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NAVAL POSTGRADUATE SCHOOL

MONTEREY, CALIFORNIA

THESIS

**ISLAMIC BANKING: FINANCING TERRORISM OR
MEETING ECONOMIC DEMAND?**

by

Ron Terrell

December 2007

Thesis Advisor:
Second Reader:

Robert Looney
Abbas Kadhim

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**ISLAMIC BANKING: FINANCING TERRORISM OR MEETING ECONOMIC
DEMAND?**

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ABSTRACT

This thesis investigates the recent world-wide rise in Islamic banking. In doing so it (1) surveys the underlying religious foundation of Islamic finance, (2) examines the attempts of Islamists to use Islamic banking to Islamize societies, and (3) assesses how countries' use of Islamic banking fit into the international economic system. Drawing on this analysis, Islamic banking is finally examined from a national security perspective – is this form of finance particularly susceptible to miss-use by terrorist groups? Although there are areas in the industry that need regulating and monitoring, this study ultimately concludes that Islamic banking's ties to terrorism are anecdotal, the expansion is the result of oil revenues and personal piety, and that Islamic banking can be leveraged as a means of moderation and enfranchisement when advanced free of an Islamist agenda.

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I. CONCEPTUAL FRAMEWORK

A. PURPOSE

Islamic banking operates under a cloud of suspicion, from being accused of knowingly financing terrorist operations to questions of its inherent structural susceptibility for such use. Once viewed as a specialized financial oddity due to its prohibition of interest, Islamic finance is now over a \$400 billion industry that is projected to grow between 10 to 15 percent a year. Islamic banks have been tied to terrorist organizations through various Islamic charities, feeding the fear that the *raison d'être* of Islamic banking is the financing of Islamic terrorism. This brings the following question: Is the Islamic banking industry growing to finance Islamic terrorist organizations or are factors such as an increase in oil revenues in the Persian Gulf States and a religious reawakening in the Muslim world creating a demand for *shari'a*-compliant banking and investment opportunities?

B. RESEARCH DESIGN

In attempting to answer this question, a review of the current literature relating Islamic banking to terrorism was conducted. This was followed by an analysis of the current banking operations, taking into consideration the historical foundations and regional differences, looking for inherent weaknesses and opportunities for exploitation by nefarious elements. Conclusions were based on the liabilities and opportunities associated with Islamic banking discovered during the process.

C. LITERATURE REVIEW

The literature that supports the industry's ties to terrorism seems to be anecdotal at best, comprising isolated incidents. Napoleoni asserts that there is collusion among Islamic banks, legitimate business, and Islamic charities in financing terrorism. She cites the Arab Bank as the financial arm of the Palestinian Liberation Organization (PLO). With a strong presence in Jordan that comprised 70 percent of its national economy by

the 1980s, the Arab Bank, primarily through the Arab Bank for Economic Development and the Arab African Bank, managed the PLO's capital outflow into other countries. Hamas, which grew out of the First Intifada, used the Al-Aqsa International Bank as its financial arm. Hamas received funding from the Holy Land Foundation for Relief and Development (HLF), a charity that collected funds for the Palestinian occupied territories, and used Bayt al-Mal Holdings for construction work. Although authorities closed these three organizations in December 2001, Hamas continues to receive funding through charities, though it is careful not to use these funds for military activities, and the Arab Bank is still in operation, but it is not an Islamic bank.¹

Napoleoni continues with describing Islamic banks' role in investing in developing countries in exchange for permission to build mosques and deploy Islamic charitable organizations to the countries, some of the latter ultimately being associated with Osama bin Laden's group. Specifically, Islamic banking made inroads into Africa, Central Asia, the Caucasus, and the Balkans with the collapse of the Soviet Union. She argues that this expansion of influence of Islamic financial and economic institutions assisted in the proliferation of armed Islamist groups and gave birth to a globalized terror economy.² She focuses on Saudi Arabia's use of Islamic banking as a means of spreading Wahabi Islam. Bin Laden had used a subsidiary of the Saudi-sponsored Dar al-Maal al-Islami (DMI) Islamic bank, ash-Shamil Islamic bank in Sudan, along with the Tadamon Islamic Bank and the Faisal Islamic Bank for transferring money to his international operatives.³

Islamic banks are involved in collecting the religious tax of *zakat*, essentially a two percent tithe, and distributing it to charities. The depositors have no control over which charities receive the funds, and some of them have had ties to Islamic terrorist organizations.⁴ Although Napoleoni claims that *zakat* is taken out with every transaction,

¹ Loretta Napoleoni, *Modern Jihad: Tracing the Dollars Behind the Terror Networks* (Sterling, VA: Pluto Press 2003), 68-72.

² Ibid., 109.

³ Ibid., 119-120.

⁴ Ibid., 120-123.

this is not necessarily the case, the frequency of deduction being at the depositor's discretion. Napoleoni also discusses the informal *hawala* system as a means of transferring money, an efficient and practically untraceable tool used by millions of Asian and African immigrants, and often the only "banking" system in failed and failing countries. Terrorists find the system appealing for its secrecy and speed of transactions.⁵ *Hawala*, though widely used in Muslim societies, is not a part of Islamic banking.

Although Napoleoni makes an interesting argument regarding Islamic banking's inherent proclivity for financing terrorism, she tends to gloss over the fact that conventional banks were also used in financing al-Qaeda terror campaigns. Conventional correspondent banks that receive money from a third bank can weaken the vetting system of the respondent bank,⁶ a tactic she fails to discuss. She also discounts the element of piety that is behind the spread of Islamic banking, many banks filling a demand by Muslims for *shari'a*-compliant banking options. Like many of the authors, Napoleoni tends to imply sweeping generalizations about the Islamic banking industry based on a few isolated incidents.

Comras discusses al-Qaeda's use of operating its own businesses as a source of funding their terrorist activities, individual cells being responsible for their own financing, and the migration from using established banking systems to more informal methods like *hawala* to make international financial transactions. In discussing al-Qaeda and its sympathizers using their own businesses to raise money for their operations, Comras mentions Al-Hamati Sweet Bakeries and two honey businesses, An-Nur Honey Press Shops and Ash-Shifa Honey Press for Industry and Commerce, all still in operation. He also names such shell corporations as Wadi al-Aqiq, Laden International Company, and Taba investment. Although the Sudanese government closed these businesses in 1998 with the expulsion of al-Qaeda, there is reason to believe that these companies, and others like them, may possess assets in many other parts of the world.⁷

⁵ Napoleoni, 123-125.

⁶ "Correspondent Banks, the Weakest Links," *Economist*, 29 September 2001.

⁷ Victor Comras, "Al-Qaeda Finances and Funding to Affiliated Groups," in *Terrorism Financing and State Responses*, eds. Jeanne K. Giraldo and Harold A. Trinkunas (Stanford: Stanford Univ. Press, 2007), 123-124.

The defeat of the Taliban in Afghanistan destroyed the pre-9/11 network of al-Qaeda, the result being that al-Qaeda's *shura*, or high command council, no longer manages the solicitation or allocation of funds. Compartmentalized, autonomous cells have assumed the responsibility of financing their own operations, utilizing local businesses, charity, and petty crime to raise funds.⁸

Although al-Qaeda used the international banking system for many of its financial transactions, maintaining accounts in numerous international banking centers including Europe and North America, the regulatory doctrines adopted after the 9/11 attacks drove al-Qaeda away from this system to more informal methods. In spite of this change, however, the financiers, businesses, and charities financing al-Qaeda "continue to make careful and prudent use of the international banking system."⁹ In addition, al-Qaeda's facilitators had established their own banking networks, such as Al-Barakaat and at-Taqwa, for covert financial transactions, although the 9/11 Commission exonerated Al-Barakaat, primarily a *hawala* operator, after it was accused of complicity in the attacks.¹⁰ Even though Comras cites at-Taqwa's suspected ties to al-Qaeda, he does not conclude that it is associated with the terrorist group because of the bank's Islamic classification. Al-Qaeda has utilized a variety of conventional, non-Islamic sources in financing its operations.

Kepel argues that Islamist¹¹ groups like the Muslim Brotherhood contributed to the establishment of Islamic banks "that would eventually finance the militant Islamist movement."¹² He describes the Islamic financial system as linking the tribal aristocracy of the Arabian Peninsula, guardians and beneficiary of the region's oil endowment, with the pious middle class, resulting in an economic partnership that satisfied the

⁸ Comras, 126

⁹ Ibid., 126-127.

¹⁰ Ibid., 127-128.

¹¹ In this thesis, Islamism is defined as the use of Islam in politics and civil governance to varying degrees, from merely a declared influence to strict application of Islamic law, dependent upon the goals of the Islamist group. Some consider Islamism to be the most fundamental interpretation of Islamism and the strictest application of *shari'a*, often at the expense of democracy. This debate is beyond the scope of this thesis.

¹² Gilles Kepel, *Jihad: The Trail of Political Islam* (Cambridge: Belknap Press, 2002), 51.

aristocracy's need for pious legitimacy.¹³ This transnational Muslim middle class, whose piety had grown with its wealth from working in the booming oil economies of the 1970s, was looking for Islamic-compliant investment opportunities that would be sheltered from the feared financial shenanigans practiced by its countries' government-controlled state banks. Kepel contends that the radical Islamists viewed these Islamic financial institutions as a place beyond the reach of established regimes to accumulate the funds that would ultimately be used to topple these regimes. He further contends that this new banking system was one of the most important factors for the expansion of Islamism in the middle class during the 1980s.¹⁴

El-Gamal argues that Islamic finance can fall victim to rent-seeking legal arbitrage by contemporary Islamic banks using premodern contract forms in the name of Islamicity. Such manipulations result in significant efficiency losses and undermine the economic purposes for which these contracts forms were codified in classical jurisprudence.¹⁵ El-Gamal further contends that *shari'a* arbitrage is inherent in Islamic finance due to the structured financial products that endeavor to keep potential borrowers or lenders separated from interest-bearing loans. This involves creating degrees of separation through multiple trades, special purpose vehicles, and the use of offshore financial centers (to minimize associated taxes and administrative costs), resembling the "layering" techniques used by money launders and criminal financiers. Citing recent corporate scandals as evidence of the lack of sophistication on the part of Western regulators, and that such expertise exists to an even lesser degree in the Islamic world, he feels that Islamic finance is particularly vulnerable to abuse by the aforementioned criminal and terrorist elements.¹⁶

Passas highlights the transition of terrorism financing from sovereign states and illegitimate transactions to more legitimate sources like legal businesses, investments,

¹³ Kepel, 76.

¹⁴ Ibid., 79-80.

¹⁵ Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), xi-xii, 176.

¹⁶ Ibid., 23-24.

charities, and cultural activities. The 9/11 Commission reported that al-Qaeda's pre-9/11 funding came from Islamic charities supported by people who were both knowledgeable and ignorant of the funds' final destination.¹⁷ Regarding methods of funds transfer, Passas cites terrorists using well-regulated financial systems (as with the 9/11 hijackers), poorly-regulated formal systems, and unregulated informal value transfer systems (IVTS). IVTS includes such mechanisms as *hawala*, physical couriers, invoice manipulation, and correspondent accounts for bank-to-bank transactions, with *hawala* drawing much attention after the 9/11 attacks based on the assumption that it was used for transferring funds for the attacks. Although al-Qaeda has used *hawala* in locations with little or no formal financial infrastructure (such as Afghanistan), *hawala* was not used for the 9/11 attacks, and there is no evidence that terrorists have used it for their operations in the United States, Canada, or Europe.¹⁸

Passas claims that IVTS was not the preferred method for terrorist funding transfers especially when formal banking networks could be utilized, but that as regulation and scrutiny over financial transactions are increased terrorists will be inclined to use more informal methods. He makes no mention of Islamic banks being any more susceptible or prone to exploitation by terrorist financiers, pointing out that the al-Qaeda used the U.S. banking system to store and transfer funds for the attack.¹⁹

Financing terrorism is also different from money laundering - since the funds slated for terrorism are not intended for legitimate use, there is no need to launder them. Moreover, since the amounts used for terrorist transactions are tiny in comparison with those associated with laundering criminal funds, typical anti-money laundering methods are insufficient to detect terrorism-related transfers.²⁰

Williams agrees with Passas that terrorists do not engage in laundering their funds in order to make them look legitimate, but that they do want to move their money

¹⁷ Nikos Passas, "Terrorism Financing Mechanisms and Policy Dilemmas," in *Terrorism Financing and State Responses*, eds. Jeanne K. Giraldo and Harold A. Trinkunas (Stanford: Stanford Univ. Press, 2007), 24-25.

¹⁸ Ibid., 29.

¹⁹ Ibid., 30.

²⁰ Passas, 34.

covertly in order to avoid attention from authorities. Accordingly, terrorist groups often use the same techniques as transnational criminal organizations. In addition to using *hawala*, al-Qaeda has used charities and established front companies to perform seemingly legitimate financial transactions in the conventional banking system.²¹ Again, why would a terrorist group endure the more complicated methods associated with Islamic banking when the conventional system will do?

James Hume, executive vice-president of the Dubai International Financial Centre, explains the rapid growth in Islamic banking as a result of the 9/11 attacks and increasing sophistication of the Islamic financial sector. He argues that the “hardening of attitudes in the West and in the Islamic countries” has precipitated a flow of funds from the West to the Arabian Gulf countries to be invested in *shari’a*-compliant financial instruments.²² An increasingly-educated international Muslim populace, growing more aware of its Muslim roots, is becoming disillusioned with conventional finance and demanding Islamic alternatives.²³

Hume cites increases in regulation and oversight as feeding the demand by changing the perception that Islamic banking is a lax and under-regulated industry. Many Islamic institutions have adopted the Accounting, Auditing and Governance standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which he argues meet or exceed the conventional banking standards. Additionally, the Islamic Financial Standards Board, with representatives from the central banks of Muslim countries, focuses on standardizing the regulatory framework for Islamic banks. Even Citibank and HSBC have entered the market and established independent Islamic banks. These new opportunities are not only being use by Muslims - non-Muslims in Malaysia are buying up almost 70% of the products offered by Islamic banks.²⁴ Hume’s argument concerning the evolution of Islamic banking into a significant

²¹ Phil Williams, “Warning Indicators and Terrorist Finances,” in *Terrorism Financing and State Responses*, eds. Jeanne K. Giraldo and Harold A. Trinkunas (Stanford: Stanford Univ. Press, 2007), 85-86.

²² “Islamic finance: provenance and prospects,” *International Financial Law Review* (May 2004), <http://libproxy.nps.edu/login?url=http://proquest.umi.com.libproxy.nps.edu/pqdweb?did=647534371&sid=1&Fmt=3&clientId=11969&RQT=309&VName=PQD>.

²³ Ibid.

²⁴ Ibid.

and legitimate financial sector is quite compelling, doing much to dispel the view that it is a tool for radical Islamists to finance the expansion of their politics and terrorist operations.

Although there have been cases of Islamic banks being involved in some way in financing terrorist activity, the literature fails to prove the assumption that Islamic banks are connected to terrorism any more than conventional banks. Furthermore, the recent surge in the Islamic financial sector is due to the growth in petroleum-related wealth and Muslim piety.

D. CHAPTER OUTLINE

Chapter II will present a theoretical and historical background in discussing the evolution of Islamic banking. In addition to presenting the philosophers and initial financiers, the role of Islamism in the establishment of an Islamic banking industry and the primary financial instruments used in Islamic banking will be explained. Chapter III will present the basic structure of an Islamic bank and compare Islamic banking in the different regions of the Muslim world, divided between the Middle East and North Africa (MENA) and Asia, and the West. Particular attention will be paid to the roles Islamism, national development, and nationalism played in the development of Islamic banking. Chapter IV will discuss the liabilities and opportunities associated with Islamic banking, from its susceptibility to abuse by criminal elements to its potential for moderating extremism. The current status of Islamic financial regulatory agencies will also be presented. Chapter V will present the conclusions of the research and recommendations for why the United States should support the development of Islamic banking.

II. THE EVOLUTION OF ISLAMIC FINANCE

After many countries in the Islamic world achieved political freedom following World War II, Muslims endeavored to revive their Islamic identity and live their lives according to the teachings of Islam. They felt that the West's political and economic hegemony over them had denied them socio-economic divine guidance. The biggest challenge for Muslims in the economic field has been to transform their financial institutions so that they comply with *shari'a* (Islamic law). The dominance of the financial system by interest has made the task more formidable. Those who do not understand *shari'a* would say that interest-free finance is a charitable undertaking, and although there is a portion of *shari'a* that advises making charitable loans for only a guaranteed return of principal, there is also a part that addresses advancing money to a party in order to share in its profits or bear the burden of its losses.²⁵

Although Islamic finance had been discussed and attempted in the past, the jump in oil prices in the early 1970s gave financiers the motivation and the means to seriously begin the Islamic finance experiment. There was also a second jump in oil prices, increasing the transfer of wealth from oil consumers to oil producers, around the same time that the Iranian Revolution of 1979 established the first Islamic republic in the region, inspiring an Islamic revival in neighboring countries that strengthened the demand for more Islamic financial institutions.²⁶ The early development of Islamic banking was not a simple economic response of supply meeting demand. Grounded in the teachings of Islam, Islamic finance started as part of a larger Islamic economics, used as a tool in the advancement of Islam as a political movement. Its origins notwithstanding, the increase in petroleum-related wealth has fueled the demand for *shari'a*-compliant financial instruments and resulted in Islamic finance's growth in the past thirty years into a significant sector in the world's financial industry.

²⁵ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: Maktaba Ma'ariful Qur'an, 2005), 9-10.

²⁶ Mohammed Akacem and Lynde Gilliam, "Principles of Islamic Banking," *Middle East Policy*, IX, 1 (Mar 2002): 124.

A. THE FOUNDATION OF ISLAMIC FINANCE

Islamic finance comes under the rubric of Islamic economics, a system derived from *shari'a* and based on three ideas: first, *tawhid* (divine unity), meaning that all economic activity must conform to divine commands as found in the *Qur'an* and *ahadith* (sayings and actions of the Prophet Muhammad and his companions); second, *khilafah* (vice regency), whereby Allah has entrusted humans with managing the world and its resources, implying a universal brotherhood; and third, *adalah* (justice), with the basic principle of economic organization being cooperation and concern for the welfare of others. Beyond these overarching principles lie positive and negative injunctions, the basis of Islamic finance being the idea of *qirad*, or profit sharing.²⁷ Although sharing profit and loss is touted as the foundation for Islamic finance, in reality the avoidance of interest (*riba*), and to a lesser degree speculation (*gharar*), is the foundation upon which all Islamic institutions are based.

Islamic scholars (*ulama*) define *riba* as any form of interest or usury,²⁸ meaning any increase returned on an amount of money borrowed, which is illegal under *shari'a*. These scholars believe that Muhammad's view of *riba* went from exhortation during the Mecca period to prohibition during the Medina period, culminating with the disregard of the prohibition of *riba* putting one at war with God and Muhammad.²⁹ The prohibition of charging interest is found in four different revelations of the *Qur'an* (30:39, 4:160-161, 3:130-131, 2:275, 278-280) shown below in order of revelation:

And [remember:] whatever you may give out in usury so that it might increase through [other] people's possessions will bring [you] no increase in the sight of God – whereas all that you give out in charity, seeking

²⁷John Barkley Rosser and Rosser, Marina V., *Comparative Economics in a Transforming World Economy*, 2nd ed. (Cambridge, Mass: MIT Press 2004): 100.

²⁸ Usury is usually considered a significant (often doubling) of the principal due to late payment.

²⁹ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press 2005), 55-58.

God's countenance, [will be blessed by Him:] for it is they, they [who thus seek His countenance] that shall have their recompense multiplied!³⁰

O you who have attained to faith! Do not gorge yourself on usury, doubling and re-doubling it – but remain conscious of God, so that you might attain to a happy state; and beware of the fire which awaits those who deny the truth!³¹

So, then, for the wickedness committed by those who followed the Jewish faith did We deny unto them certain of the good things of life which [aforetime] had been allowed to them; and [We did this] for their having so often turned away from the path of God, and [for] their taking usury although it had been forbidden to them, and their wrongful devouring of other people's possessions.³²

Those who gorge themselves on usury behave but as he might behave whom Satan has confounded with this touch; for they say, "Buying and selling is but a kind of usury" – the while God has made buying and selling lawful and usury unlawful. Hence, whoever becomes aware of his Sustainer's admonition, and thereupon desists [from usury], may keep his past gains, and it will be for God to judge him; but as for those who return to it – they are destined for the fire, therein to abide! O you who have attained to faith! Remain conscious of God, and give up all outstanding gains from usury, if you are [truly] believers; for if you do it not, then know that you are at war with God and his Apostle. But if you repent, then you shall be entitled to [the return of] your principal: you will do no wrong, and neither will you be wronged. If, however, [the debtor] is in straitened circumstances [grant him] a delay until a time of ease; and it should be of your own good – if you but knew it – to remit [the debt entirely] by way of charity.³³

³⁰ *Qur'an* (30:39). According to the translator's, Muhammad Asad's, notes this is the first mention of *riba* in the Qur'anic revelation, denoting an "'increase' or 'addition' of a thing above its original size or amount; it signifies an addition, by way of interest, to a sum of money or goods lent by one person or body of persons to another. ...Islamic scholars have not yet been able to reach an absolute agreement on the definition of *riba*: a definition, that is, which would cover all conceivable legal situations and positively respond to all the exigencies of a variable economic environment."

³¹ *Qur'an* (30:130-131).

³² *Qur'an* (4:160-161).

³³ *Qur'an* (2:275,278-280). Asad also notes that this prohibition of *riba* by the Prophet in legal terms, having died a few days later, prohibiting his companions from asking him about the *shari'a* implications with respect to this injunction. He further asserts that in spite of this explicit condemnation of *riba*, particularly as it relates to "an exploitation of the economically weak by the strong and resourceful," the type of financial transactions falling under this characterization of *riba* is a moral question.

In short, these verses express the following ideas: only profits from trade are allowed, *riba* cheapens God's blessings, *riba* is equated to stealing others' property, and Muslims should avoid *riba* for their own welfare. This has formed the basis for Islamic banking whereby lenders must be willing to share in borrowers' profits or losses in order to be compliant with *shari'a*.³⁴

The existence of a pre-Islamic *riba* (*riba al-jahiliyya*), a form of crippling interest that doubles a debt if unpaid at maturity, has sparked much debate regarding the prohibition of interest in Islam. Mohammed Said al-Ashmawi feels that the sweeping prohibition of *riba* is unwarranted based on three arguments: first, the *riba* discussed in the *Qur'an* is of the pre-Islamic variety which could result in the enslavement of a borrower that could not pay; second, a widely-quoted *hadith* (singular of *ahadith*) mentions six commodities with respect to *riba*, modern currency not being in existence at the time; and third, a distinction should be made between exploitative loans made to poor individuals to meet basic needs and economically useful loans taken to invest in legitimate, profit-making ventures.³⁵ Numerous *fatwas* (legal opinions) have been issued in support of limited interest-bearing transactions (most notably in 1989 by the mufti of the Egyptian Republic, Muhammad Sayyid Atiyya Tantawi), but these have been dismissed by the majority of the Islamic World.³⁶

The majority of *shari'a* scholars believe *riba* is prohibited because it is unfair, exploitative, and unproductive. According to Islam, risk should be shared by the borrower and the lender, as opposed to the borrower alone either incurring the entire loss or reaping extraordinary benefits and the lender making money no matter the outcome of

³⁴ Warde, 58.

³⁵ William E. Shephard, "Muhammad Sa'id Al-Ashmawi and the Application of the *Shari'a* in Egypt," *International Journal of Middle East Studies*, 28, 1 (February 1996): 46-47.

³⁶ Warde, 57.

the enterprise. While the proportion of the profit or loss must be agreed upon by the parties ahead of time, there cannot be a pre-determined, fixed compensation in the form of interest.³⁷

Although often ignored by many writings on Islamic finance, another of its foundations is the avoidance of *gharar*, loosely defined as uncertainty, risk, or speculation, but not the risk normally associated with normal commercial transactions. *Gharar* refers to “transactions conditioned on uncertain events,” and although not mentioned in the *Qur'an* by name, it is associated with the prohibition of playing Maysir (a game of chance played by Arabs, but usually associated with all games of chance (*Qur'an* [2:219, 5:90, and 5:91])).³⁸ A number of *ahadith* condemn *gharar*, specifically as they relate to commercial transactions involving uncertainty:

The Messenger of God forbade the “sale of the pebble’ [*hasah*, sale of an object chosen or determined by the throwing of a pebble], and the sale of *gharar*.

Do not buy fish in the sea, for it is *gharar*.

Whoever buys foodstuffs, let him not sell them until he has possession of them.³⁹

Strict adherence to the idea of *gharar*, which would make modern-day transactions found in the Western world practically impossible under Islamic finance, has precipitated intense debate among Islamic scholars from the various legal schools over the years. Ibn Taymiyya (d. 1328), who sought to refashion contract law under *fiqh* (Islamic jurisprudence), influenced later schools and is held in high regard by most modern practitioners for his unique positions. He argued that interpreting *gharar* so as to completely bar the nonexistence and lack of knowledge would unduly restrict contractual freedom resulting in overt legalism and a reduction in people’s welfare. Viewing *gharar*

³⁷Warde, 63.

³⁸ Ibid., 59.

³⁹ Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk, and Return* (The Hague: Kluwer Law International, 1998), 87-88.

as a question of degree, he resolved that uncertainty can never be completely removed from a contract and that a contract may have minor *gharar*.⁴⁰

B. THE BEGINNING OF AN ISLAMIC FINANCIAL SYSTEM

In spite of the historical roots, Islamic finance as it is practiced today was born after World War II through the idea of Islamic economics, part of a move in late-colonial India to advance an Islamic character as a means of identity creation and protection. The rhetoric of the doctrine, however, is that Islamic economics has existed since the dawn of Islam, and Islamic economists are merely uncovering the forgotten yet eternal teachings. Sayyid Abul-Ala Mawdudi, founder of *Jamaat-I Islami* (Party of Islam), first in India and then in Pakistan, rejected the idea of a separate homeland for Indian Muslims, advocating instead a cultural reassertion rather than political separation. He promoted the idea of Islamic economics as a means of rediscovering the traditions that once brought Islam its power, glory, and prosperity. He feared that the illusion of communal safety that would accompany the creation of Pakistan would reduce Islam's relevance to daily life. Economic activity in particular, because it occurs outside the home, would be a way of keeping Islam continuously in public view, heightening Islam's visibility. Due to the vast amount of time associated with economic activity, Mawdudi felt it was imperative to make it a religious activity in order that economic development, often associated with the secular West, would increase the perceived role of Islam in the lives of Muslims.⁴¹

Islam being a religion more concerned with orthopraxy (behavioral correctness) over orthodoxy (doctrinal correctness), Mawdudi sought to update this orthopraxy in a way that would sustain communal identity. Essentially a reformist Islamist, he was seeking a religious revival that promoted modernization without Westernization. With economic change being central to modernization, he advocated the development of Islamic economics as the economic component of a new Islamic orthopraxy.⁴²

⁴⁰ Vogel and Hayes, 92-93.

⁴¹ Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (Princeton: Princeton University Press, 2004), 83-85.

⁴² *Ibid.*, 89, 91.

In his *The Economic Problem of Man and its Islamic Solution*, Mawdudi contends that man's economic problem is how to organize economic distribution in order to supply all men with the basic necessities for existence with the ultimate goal of sustaining and developing civilization. Furthermore, he felt it imperative that everyone must be given the opportunity to maximize his personal potential in accordance with his capabilities. He criticized the world's tendency to separate this economic problem from the larger part of human life, considering it the sole problem of life, and that the whole scheme of life needs to be examined.⁴³ This formed the basis for his argument of the need for an Islamic economics since all of life was to be lived in accordance with Islam.

Mawdudi argued that man's natural selfish tendency to exceed the limits of moderation, exacerbated by other immoral habits, was supported by a political system with no moral basis. Although he believed that it was naturally acceptable for there to be moderate economic disparity among men, man's failure was his selfish accumulation of other people's wealth, specifically through lending money on interest and investing in commercial activities. By setting aside wealth for savings or investment, the wealthy leave consumer goods unpurchased, ultimately resulting in a spiraling debt and a decreasingly smaller wealthy class and an increasingly larger poor class.⁴⁴

In line with Islam's support of commerce and private property, Mawdudi was critical of communism and fascism as potential answers to man's economic problem. He described communism as an attempt to treat "the economic problem as the central problem and then tries to revolve the whole of human life around this axis." Although the whole community is supposed to share ownership of the means of production and distribution of products, ultimately the management of these resources will be assumed by a small executive body and the community will be subject to its whims. He viewed fascism in much the same light. Although individual ownership of the means of production would remain, the coercive power of the state would enslave the people.⁴⁵

⁴³ Sayyid Abul-Ala Mawdudi, *The Economic Problem of Man and Its Islamic Solution* (Lahore: Islamic Publications (Pvt.) Limited, 1947/1992), 5, 10-11.

⁴⁴ Ibid., 16-23.

⁴⁵ Ibid., 28-33.

Mawdudi offered Islam as a third way, a solution based on staying on the natural path, creating the right moral attitude among men, and minimizing state involvement in the economy. In his societal model, man would retain the fruits of his labor and conduct business in a way that did not exploit the weaker sections of society, taking care not to engage in activities that are unlawful (*haram*) under Islam (such as drinking alcohol, music, dancing, bribery, stealing, speculation, etc.). Life should be lived in a decent manner of average standard, with surplus wealth being used to advance public welfare and help those that are less fortunate. An Islamic society would respect those who earn and spend over those who hoard or invest their wealth. He emphasized the legal limitations Islam has placed on the use of surplus wealth, specifically lending money for interest. Using surplus wealth as an investment should be done as a joint undertaking whereby all parties share in the profits and losses.⁴⁶ These ideas were to be the foundation for Islamic finance.

Mawdudi emphasized the importance of the Muslim *umma* (community) and its expectation of solidarity under traditional Islamic principles, along with the traditions and similarities of the world's Muslims. He argued that restoring the vitality of the *umma* would overcome any cultural, linguistic, historical, and political differences. He used Islam's "Golden Age," the twenty-nine-year period of the four "rightly guided" caliphs, as evidence of the cooperation, justice, and self-sacrifice capable under Islamic solidarity. Additionally, Mawdudi did not believe Islam and the West could coexist, in line with Samuel Huntington's "clash of civilizations." Islam and the West were at war over the loyalty of Muslims and economics was to be one of the battle grounds.⁴⁷

Muqtada as-Sadr, another prominent Islamic thinker, laid out his plan for an Islamic economic system in his *Iqtisaduna* (Our Economics). His concept of Islamic economics comprised three main principles: first, double ownership whereby the distribution system is defined; second, economic freedom limited by Islamic values pertaining to production, exchange, and consumption; and third, a social justice based on

⁴⁶ Mawdudi, 33-38.

⁴⁷ Kuran, 94-99.

reciprocal responsibility and balance in order to ensure happiness.⁴⁸ As-Sadr found absolute capitalism and socialism flawed because of their fundamental, and seemingly exclusive, beliefs in private ownership and public ownership, respectively. He argued that the Islamic system was superior due to its ability to see the need for a combination of private and public ownership. Regarding economic freedom with respect to these two systems, he found the unrestricted freedom of capitalism and the contrasting constraints of socialism to be incongruent with society's overall well-being, while Islam's system was more in line with man's nature. Humanity benefited by placing restrictions on social freedoms in the economic field that were in line with Islam's values and ideals. These restrictions comprised two areas: personal, based on the "spiritual and ideological content of the Islamic personality," and societal, where "an external power...defines and regulates the social behaviours." Both of these would be under the authority of *shari'a*.⁴⁹ The third element, social justice, would be realized through general reciprocal responsibility and social balance, both of which, through their Islamic sense, would precipitate the social values and justice that would ensure a just distribution of wealth in society.⁵⁰

At this point, one can discern that as-Sadr's doctrine focused on the idea of justice and that man's personal and social interests were in conflict. He believed that the "rational economic man" is incompatible with the Islamic economic system, and that Islamic man's belief in the spiritual world is required for the Islamic economic system. Moreover, he sees flaws in allowing individuals to satisfy their personal desires due to the concomitant creation of socio-economic problems.⁵¹ "It is realized from all this that the crux of the social problem is but the personal impulse and that this impulse is deeply rooted in man as it springs from his love for his ownself."⁵² Although the market and the

⁴⁸ Muhammad Baqir as-Sadr, *Iqtisaduna - Our Economics*, Vol. 1, Part 2 (Tehran: World Organization for Islamic Services, 1994), 51, 62.

⁴⁹ Ibid., 52-57.

⁵⁰ Ibid., 60-61.

⁵¹ Mohamed Aslam Haneef, *Contemporary Islamic Economic Thought - A Selected Comparative Analysis* (Selangor: Ikraq, 1995), 111-113.

⁵² As-Sadr, 84.

state have roles to play in his Islamic economic system, the overriding influence and guidance would come from Islam⁵³ - “Hence comes the role of religion being the only solution of the problem because religion constitutes the only framework in which the social problem could be solved.”⁵⁴ As-Sadr’s Islamic economic system could not stand alone, however, but was a part of an entire Islamic society that would guide the various aspects of life in such a society.⁵⁵

Like other Islamic economists, as-Sadr believed that distribution (ownership) of a society’s resources should be based on a man’s work, and that need should also play a role. He realized, however, that there must be a balance, since a distribution system that focused solely on need would undermine itself by reducing the incentive to produce, as was the case with communism. While he believed that private wealth comprised things that were taken from the earth, such as agricultural commodities or fish, the land and the sea constituted public wealth and could not be privately owned because the basis of private ownership was work.⁵⁶

He saw problems in the modern age with the cash system, in contrast to the barter age where there was a balance between supply and demand. The modern age saw suppliers selling their products to acquire cash that they would subsequently hoard, taking it out of productive circulation. Such hoarding can disrupt markets by creating false demands or predatory pricing to remove competitors, to the detriment of society. Interest drives this disruption in society’s harmony by incentivizing its citizens to hoard cash in order increase wealth through interest. Whereas an investor could benefit society by financing a project that could increase society’s overall productivity, he may instead choose to keep his money in an interest-bearing account due to its more favorable rate of return. Under Islam, such usurious activity was strictly forbidden, helping to maintain the general economic balance.⁵⁷

⁵³ Haneef, 114.

⁵⁴ As-Sadr, 84.

⁵⁵ Ibid., 66.

⁵⁶ Ibid., 113-127.

⁵⁷ Ibid., 136-141.

According to Justice Muhammad Taqi Usmani, the unbridled profit motive of secular capitalism drives economic decisions and, through such tools as interest and speculation, creates monopolies and concentrates wealth in the hands of the few. There is no divine guidance to encourage the natural process of supply and demand and control economic activities. Under Islam, the divine restrictions on such economic activities as *riba*, hoarding, short sales, and speculative transactions “have a cumulative effect of maintaining balance, distributive justice, and equality of opportunity.”⁵⁸ Although Islamic economics seems to address the majority of social ills supposedly associated with western market economies, it has little to say about dealing with such annoyances as inflation.

C. THE CREATION OF ISLAMIC FINANCIAL INSTITUTIONS

The basic idea behind Islamic economics, that within Islam lay a means of conducting financial affairs, took form in Islamic banks in the second half of the twentieth century.⁵⁹ The first known successful Islamic bank was in Kuala Lumpur, the Pilgrims’ Administration and Fund (Tabung Hajji) established a few years after Malaysia’s independence in 1956. The newly-independent government supported the idea of a bank that catered to Malays who made up the poor and Muslim majority of Malaysian society. The Malay population, mainly rural peasants living a subsistence existence, liked the idea of an institution that would finance the *hajj* (spiritual trip to Mecca). The Fund, controlled and sponsored by the government, ensured a large number of depositors by requiring all Malays to process their *hajj* papers through the Fund, making it convenient for them to keep their savings with it as well. Beginning with investing *hajj* savings in accordance with *shari’a*, the Fund expanded into real estate, industrial, and agricultural sectors. It developed its own ideas and Islamic financial instruments independently from the Middle East, Middle Eastern Islamic financiers remaining ignorant of the Malaysian institution until it was discovered through a

⁵⁸ Usmani, 17-18.

⁵⁹ Mohammed Malley, “Jordan: A Case Study of the Relationship between Islamic Finance and Islamist Politics,” in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 191.

presentation to the Islamic Development Bank during negotiations to establish the Islamic Bank of Malaysia.⁶⁰ This separation explains the difference in regional banking products that will be discussed later.

The Muslim Brotherhood in Egypt embraced Islamic banking as a vehicle for advancing political Islam. This initial relationship evolved into a mutually-beneficial one between the conservative Islamism of the Arab world and the expertise of several leading Western banks, financial institutions, and universities.⁶¹ According to most scholars, the first physical manifestation between Islamism and Islamic finance occurred in 1963 with the creation of the Mit Ghamr Bank by Ahmed an-Najjar, a German-trained Egyptian banker. After receiving his PhD in social economics in Germany, an-Najjar returned to Egypt in order to establish a bank based on the German savings bank model. After receiving German support for his project, he contacted the director of the State Intelligence Agency (al-Mokhabarat) through family contacts. Al-Mokhabarat introduced him to officials in the Ministry of Economy who finally approved his project. With President Gamal Abd an-Nasser vehemently opposed to the Muslim Brotherhood and their Islamic cause, an-Najjar was careful to distance himself from Islam, never making any reference to it for fear that his project would be rejected.⁶² Even with the bank's charter excluding any references to Islam, the bank earned profits through direct partnerships with industry and other profit-sharing enterprises, never charging or paying interest.⁶³ However, at the time neither this bank nor Tabung Hajji in Malaysia offered current accounts or check facilities, failing to satisfy the daily commercial transactions of regular businesses.⁶⁴

⁶⁰ Monzer Kahf, "Islamic Banks: The Rise of a New Power Alliance of Wealth and *Shari'a* Scholarship," in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 18-19.

⁶¹ Robert Dreyfuss, *Devil's Game: how the United States helped unleash fundamentalist Islam* (New York: Henry Bolt and Company, LLC, 2005), 178-179.

⁶² Samer Soliman, "The Rise and Decline of the Islamic Banking Model in Egypt," in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 267-268.

⁶³ Warde, 73.

⁶⁴ Kahf, 20.

Some have questioned an-Najjar's contention that he created the first Islamic bank since he had told neither the public nor the state of his Islamic motivation. "Just as there is no Islamic movement without reference to Islam, there can be no Islamic bank without an Islamic reference and discourse. Hostility to usury is not specific to Islam. What makes a bank Islamic is therefore not avoidance of interest alone but the location of this avoidance in an Islamic framework and discourse that prohibits *riba*."⁶⁵ Jamal al Banna, brother of Hassan al-Banna, founder of the Muslim Brotherhood, counters this view in an unpublished book he wrote that describes the founding of the Mit Ghamr Bank. According to Jamal al-Banna, an-Najjar did "not consider Islamic economics as a science or a study, but as a cause for awakening the Muslims, and a method for their renaissance. Therefore, he considers 'Islamic banks' only as a base for his mission." An-Najjar claims to have started his bank as a counter to the Marxism and nationalism that was beginning to sweep Egypt at the expense of Islam. Nasser's opposition to Islamic political activity and the Muslim Brotherhood precluded an-Najjar from stating his true goals.⁶⁶ Others have countered that an-Najjar revealed his zeal and accomplishment only after Islamic banking was legalized in the late 1970s.⁶⁷

Investing in many of an-Najjar's early ventures, the Muslim Brotherhood was deeply involved in his work and had infiltrated Mit Ghamr as clients, depositors, and employees.⁶⁸ At its closure by the state in 1967, Mit Ghamr had nine branches and 250,000 depositors. After his bank's closure, an-Najjar traveled to Sudan, Germany, Saudi Arabia, the United Arab Emirates, and Malaysia promoting Islamic banking and over the next 30 years would appear wherever an Islamic bank opened, including when the Saudi-backed Organization of the Islamic Conference (OIC) commissioned the Islamic Development Bank (IDB) in Jeddah in 1974. According to an-Najjar, he met Prince Mohammed al Faisal al Saud (son of King Faisal) at an IDB meeting in the early

⁶⁵ Soliman, 268.

⁶⁶ Dreyfuss, 179.

⁶⁷ Soliman, 268.

⁶⁸ Kahf, 19.

1970s. Prince Mohammed and Sheikh Saleh Kamel, another disciple of an-Najjar, would establish empires in the world of Islamic banking.⁶⁹

An-Najjar's bank had been popular among the poorer elements of Egyptian society, encouraging saving and assisting small-scale entrepreneurs. Possibly in response to public pressure to provide a replacement after Mit Ghamr's closure, the government of Egypt established the Nasser Social Bank (NSB) in 1971 as a de facto Islamic bank. The state mandated such Islamic principles as interest-free financing and *zakat* (alms-giving), charging the bank with accepting voluntary *zakat* and distributing it according to *shari'a*.⁷⁰ Ostensibly, the state established the NSB to foster social solidarity and assist the poorer members of Egyptian society,⁷¹ but there was also a political motive. President Anwar as-Sadat, having inherited the leftist-leaning groups from the Nasser years, needed the support of the Islamists in his crackdown on the remaining Nasserites and purge of the Arab Socialist Union.⁷² Ironically, the charter used tenets from Arab socialism rather than Islam to explain interest-free banking practices, and the Ministry of Social affairs, which has no religious competence, was responsible for the bank's management. Again, due to the lack of an Islamic reference in the bank's name and charter, some would not consider the NSB an Islamic bank. The importance in distinguishing the Mit Ghamr and NSB from Islamic banks is due to the logic behind their establishment. The former assists the poor by encouraging saving and mobilizing their resources, filling a social and economic need along with conventional banks. Islamic banks are based and developed "on the idea that all other banks are illicit and that Islamic banks should replace them."⁷³ This differentiation may be useful in analyzing the role of Islamism in banking, but unimportant economically as Islamic financial products, once utilized by only the pious, are also being used by Muslims and non-Muslims for portfolio diversification.

⁶⁹ Dreyfuss, 179-180.

⁷⁰ Kahf, 19.

⁷¹ Warde, 74.

⁷² Kahf, 33.

⁷³ Soliman, 269.

Although Pakistani scholars had done most of the theoretical work on Islamic financials systems since the 1940s, the political and economic events associated with pan-Islamism (following the defeat of the Arab states at the hands of Israel in the 1967 war) and the increase oil prices in the early 1970s created the incentives to transform the theory to reality. The OIC, created in 1970 and largely dominated by Saudi Arabia, took the lead in establishing Islamic banking. The quadrupling of oil prices in 1973-74 helped convince King Faisal of Saudi Arabia that a pan-Islamic bank would assist the Islamic world in gaining more control over its economic and political destiny.⁷⁴ Specifically, “the idea of establishing an international development bank for the Islamic world was suggested for two main reasons: 1) to enhance the OIC as a potential power base for some of the newly enriched countries, especially Saudi Arabia and Algeria; and 2) to serve as a buffer institution for distributing financial aid from the Muslim oil-exporting countries, especially the Gulf states, to their brethren in Africa and Asia.”⁷⁵ It was also believed that a *shari’a*-compliant bank would attract idle money that had deliberately been kept out of conventional banking. Created at the 1974 OIC summit in Lahore, the inter-governmental IDB was to become the foundation of Islamic banking. Beyond assisting cash-starved regions, providing fee-based financial services, managing income received from interest earned from non-Muslim countries and *zakat* funds, and serving as an international payment clearinghouse between Muslim countries, it would provide the expertise to promote the creation of additional Islamic institutions. Of the forty-four founding member countries, the largest shareholders were Saudi Arabia (25%), Libya (16%), the United Arab Emirates (14%), and Kuwait (13%).⁷⁶

The Dubai Islamic Bank (DIB), considered to be the first modern, private Islamic bank, was created in 1975 by a successful local entrepreneur with ties to the ruling family of Dubai. His background and socio-political connections allowed him to operate the bank according to his own management style and understanding of *shari’a*. Both the DIB and IDB had been established without *shari’a* boards - at the time there was not a

⁷⁴ Warde, 74.

⁷⁵ Kahf, 20.

⁷⁶ Warde, 74-75.

manual or clear understanding of how a *shari'a*-compliant large-scale bank should operate. The banks separately approached *shari'a* scholars, seeking their consultations on operations and *fatwas* on specific questions. With only minor exceptions, the activities of both banks were *shari'a*-compliant, but only in 1999 did the DIB establish its own *shari'a* council, and the IDB waited until 2003.⁷⁷

During the next ten years, Islamic banking spread throughout the Middle East: Kuwait Finance House (1977), Faisal Islamic Bank of Egypt (1977), Islamic Bank of Sudan (1977), Jordan Islamic Bank of Finance and Investment (1978), Bahrain Islamic Bank (1978), and International Islamic Bank for Investment and Development in Egypt (1980). Islamic finance also spread beyond the region in the form of international investment banks in such places as Nassau, Geneva, and Manama. This surge in Islamic financial institutions was due to the efforts of the previously-mentioned Prince Muhammad and Saleh Kamel.⁷⁸

Prince Muhammad's establishment of the Faisal Islamic Bank of Egypt was not only the foundation for his Islamic banking empire, but it also established the alliance between bankers and the *ulama*. The Prince knew that his prior relationship with an-Najjar would be a liability in establishing a private Islamic bank in Egypt, and he would have to distance himself from the Muslim Brotherhood because "its elitist style precludes it from offering him contacts with businesses in Egypt and other Arab countries." Needing someone who would be acceptable to the local populace, the Islamists, and the government, the Prince engaged the Grand *Mufti* of Egypt, the country's most senior Islamic jurist. He was able to provide the Prince with local legitimacy and still maintain his good relations with the government; the latter being especially important since a special law was needed to establish Egypt's first private Islamic bank. This was the beginning of the alliance between the *ulama* and bankers that would prove significant for the next 25 years. These *shari'a* scholars were important for their close contact with the small and medium-sized businessmen and middle-income earners whom the bankers hoped to attract, enjoying a rapport with the Muslim populous unknown by the Islamic

⁷⁷ Kahf, 22.

⁷⁸ Warde, 75.

economic and financial elite and Islamists at the time. In exchange for an agreement by Islamic bankers to conduct operations in accordance with *shari'a*, to include not only the prohibition of interest but also the other financial transactions covered by *fiqh* (Islamic jurisprudence), the *ulama* gave the bankers credibility and legitimacy.⁷⁹

Prince Muhammad's work did not end in Egypt. In 1977 he established the International Association of Islamic Banks as a source of expertise for new Islamic banks. One of its first endeavors was the *Handbook of Islamic Banking*, designed to be a practical source of information for bankers and "the definitive reference for Islamic institutions."⁸⁰ Prince Muhammad established the international network known as the Faisal Group, comprising all or part of the Jordan Islamic Bank, the Faisal Islamic Bank of Sudan, and Faisal Finance House in Turkey. The nerve center of his empire, however, was the Dar al-Maal al-Islami (House of Islamic Funds), or DMI, a holding company founded at an Islamic summit in Taif, Saudi Arabia in 1981. With a large international reach, DMI is based in the Bahamas, maintains its operations center in Geneva, and at one time enjoyed subsidiaries in Bahrain, Pakistan, Turkey, Denmark, Luxembourg, Guinea, Senegal, and Niger.⁸¹

Saleh Kamel, brother-in-law of then-Saudi Crown Prince Fahd and a leading member of the Muslim Brotherhood, founded the Al-Baraka group and was managing director of the Saudi family-controlled Al-Baraka Investment and Development Company which operates on a non-interest basis. In addition to sponsoring annual seminars which bring together economists, bankers, and *shari'a* scholars, Kamel established the Saleh Kamel Center for Islamic Economic Studies at al Azhar, the thousand-year-old center for Islamic learning in Cairo.⁸²

⁷⁹ Kahf, 22-24.

⁸⁰ Warde, 76.

⁸¹ Richard Labeviere, *Dollars for Terror: The United States and Islam* (New York: Algora Publishing, 2000), 240.

⁸² Drefuss, 180; Kahf, 24; Endre Stiansen, "Interest Politics: Islamic Finance in the Sudan, 1977-2001," in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 157.

Oddly enough, Prince Muhammad and Kamel, both prominent Saudis and heads of the two largest Islamic banking groups, were refused licenses to operate commercial banks in Saudi Arabia. This refusal was due to the paradox of power of Saudi Arabia's ruling family - its legitimacy is tied to Islam, but the management of its economy and banking system are based on conventional practices. To recognize an Islamic bank would be de-facto recognition that all other banks in Saudi Arabia are un-Islamic. Although officially all banks are classified as Islamic, non-royal Ar-Rajhi Banking and Investment Company (ARABIC), authorized in 1985 to conduct interest-free banking, is forbidden to use the word Islamic in its name. Interest generated by the country's vast bank deposits and foreign assets are often known by other names.⁸³

Throughout the 1970s and 1980s, DMI and Al-Baraka developed close ties with institutions in London, New York, Hong Kong, Switzerland, the Bahamas, and the Cayman Islands. During an Islamic banking conference in Baden-Baden, West Germany, Ibrahim Kamel, DMI's vice chairman and CEO, credited Price Waterhouse for its contribution to establishing DMI's Geneva operations center: "The people who explained [Islamic Banking] to the Swiss Banking Commission are Price Waterhouse, who have been auditing us for over three years." Western financial centers have hosted dozens of Islamic banking conferences, and, in partnership with Islamic banks, have founded Islamic financial research programs in Western universities, such as the Harvard Islamic Finance Information Program (HIFIP) in 1995.⁸⁴

D. ISLAMIC FINANCIAL INSTRUMENTS

Islamic finance goes beyond merely the prohibition of interest to the idea that money should be based on equity rather than debt. In lieu of interest, Islamic banking uses the profit and loss sharing (PLS) system whereby the bank and the borrower make an agreement on how to divide the share of profits or burden of losses for a financed enterprise. Money is not considered capital in Islam, but potential capital, with returns only justified if there is a risk of loss. Contrary to conventional banking where the

⁸³ Warde, 208.

⁸⁴ Dreyfuss, 181.

practice preceded the theory, in Islamic banking the theory preceded the practice with the underlying rules revealed in the *Qur'an* and *ahadith*.⁸⁵

Asset-backed (or equity-based) financing is at the heart of Islamic banking since money has no intrinsic value under Islam and is simply a medium of exchange. All units of the same currency are equal, so they cannot be traded for profit. Profit can only be generated through selling items with intrinsic utility or exchanging different currencies. Capital is not separate from entrepreneurship - by contributing capital in the form of money to a commercial venture an investor assumes risk and is entitled to a proportionate share of the actual profit. The primary instruments of Islamic finance are *musharaka*, *mudaraba*, *murabaha*, *ijara*, *salam*, *istisna'* and *sukuk*.⁸⁶

1. Musharaka

Musharaka (sharing) is a joint enterprise in which the profit or loss of a joint venture is shared by the partners in pre-determined proportions. All partners are entitled to engage in management of the enterprise unless there is an alternate agreement among all the partners. Cash or commodities may be contributed as share capital in a *musharaka* contract, and it is not valid under *shari'a* if the terms of profit distribution are not spelled before the contract goes into effect. Although Muslim jurists disagree as to the appropriate ratio for sharing profits (whether they should be distributed in proportion to the amount of capital invested versus another ratio agreed to by the partners), they unanimously agree that each partner's share of the losses be in proportion to his amount invested.⁸⁷

A partner may leave a *musharaka* merely by giving written notice to the other partners. Although this can be used to completely dissolve the *musharaka* this need not be the case if the other partners wish to continue the enterprise. If there is a dispute as to the value of the departing partner's shares, he may compel the other partners to liquidate and distribute all assets. The exception to this situation would be in the case of a large,

⁸⁵ Akacem and Gilliam, 125-126.

⁸⁶ Usmani, 18-23.

⁸⁷ Ibid., 33-42, 48.

long-term project in which vast sums of money have been invested and the termination of the project in its infancy could be “fatal to the interests of the partners, as well as to the economic growth of the society,” in which case the partner would be denied the right of liquidation or separation. This is supported by the following *hadith* of the Prophet Muhammad:

All the conditions agreed upon by the muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.⁸⁸

Musharaka can also be used as a method of finance under a diminishing partnership (*musharaka mutanaqisah*). Under this arrangement, ownership is shared between the customer and the financial institution, with the customer's payments constituting a rent on the financial institution's share of the property and a principal payment so that the customer is buying the institution's shares of the property over time.⁸⁹

2. Mudaraba

Mudaraba is a special profit-sharing enterprise where one partner serves as the investor and only provides the capital and the other partner is the entrepreneur and provides the management and labor. Unlike a *musharaka*, the investor is excluded from management, the sole responsibility of the entrepreneur. Although the ratio of profit sharing is established in the contract, unlike a *musharaka*, the investor suffers any and all losses. The logic behind this difference is that should the enterprise fail the entrepreneur's labor will have been fruitless and constitutes his share of loss. With the exception of daily expenses and food (although on this the *ulama* are not unanimous), the entrepreneur cannot claim a periodic salary or fee of any kind for his work done in support of the *mudaraba*. Additionally, the investor's liability is limited to his investment unless he gave the entrepreneur permission to incur additional debts. Either party can terminate the contract with written notification to the other party. Since all

⁸⁸ Usmani, 27, 42-45.

⁸⁹ Mahmoud A. El-Gamal, “A Basic Guide to Contemporary Islamic Banking and Finance,” <http://www.ruf.rice.edu/~elgamal/files/primer.pdf>

assets purchased by the entrepreneur are the sole property of the investor, only the profit is distributed at termination in accordance with the predetermined ratio (assets may need to be liquidated in order to make this distribution).⁹⁰

3. Murabaha

Murabaha, the most widely-used of all the *shari'a*-compliant financial instruments in Islamic banking is a term of Islamic *fiqh* where one person sells another a commodity at cost plus a certain profit with payment being made on the spot or in the future. In its original Islamic connotation, *murabaha* was simply a sale, its distinguishing feature being the disclosure of the cost and profit to the buyer. (Simply selling a commodity at profit without revealing the cost is called a *musawamah*.) Although Islamic jurists have written volumes on the vast and intricate rules governing the contract of sale, the rules relevant to *murabaha* transactions are as follows:

1. The subject of sale must be existing at the time of sale.
2. The subject of sale must be in the ownership of the seller at the time of sale.
3. The subject of the sale must be in the physical or constructive possession (commodity is in control of the seller with all its rights and liabilities) of the seller when it sells it to another person.
4. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void.
5. The subject of sale must be a property of value. Thus, a thing having no value according to the usage of trade cannot be sold or purchased.
6. The subject of sale should not be a thing which is not used except for *haram* (forbidden) purposes, like pork, wine, etc.
7. The subject of sale must be specifically known and identified to the buyer. The subject of sale may be identified either by pointation or by detailed specification which can distinguish it from other things not sold.

⁹⁰ Usmani, 47-52.

8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.
9. The certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.
10. The sale must be unconditional. A conditioned sale is invalid unless the condition is recognized according to the usage of trade as a part of the transaction.

Additionally, payment may be deferred (known as a *bai' mu'ajjal*), the seller can assess penalties for late payment (but they must be donated to charities), and a promissory note or bill of exchange signed by the buyer can only be sold at its face value.⁹¹

Originally a particular type of sale, *murabaha* was never intended to be a mode of financing, only a means of avoiding interest, a stepping stone during the Islamization of an economy to the preferred *musharaka* and *mudaraba*, considered by the *ulama* to be better instruments for implementing the economic objectives of Islam. Therefore, the *ulama* have instituted strict guidelines in order to draw a clear line between a *murabaha* transaction and a conventional loan. In addition to the aforementioned requirements, the additional guidelines include the following: first, *murabaha* can only be used to purchase commodities and not fund daily operating expenses; second, although it is preferred that the financier purchases and takes possession of the commodity, when this is not practicable, the customer may act as the financier's agent, buy the commodity on his behalf, and then buy it from the financier; third and most important, the institution must bear the risk of the commodity in between initially buying the commodity and selling it to the customer.⁹²

Due to *murabaha*'s apparent similarity to conventional financing, it has become a source of debate in the world of Islamic banking, particularly as it relates to the ideas of the time value of money, using interest rates as a benchmark for mark-ups, collateral, and securitization of a *murabaha*. First, a sale based on deferred payment is interest only

⁹¹ Usmani, 95-101.

⁹² Ibid., 104-108.

when the item being exchanged for an increase in price is money itself, which has no intrinsic value in Islam. When a commodity is being sold in exchange for money, a seller may increase the price of a product because he is extending “credit” to the buyer, which is acceptable under *shari’a*. Second, many Islamic institutions use an interest rate like the London Interbank Offered Rate (LIBOR) as a benchmark for calculating an appropriate profit or mark-up for a *murabaha*. While not desired due its resemblance to charging interest, the use of such a benchmark does not render the transaction *haram* since no interest is being assessed and currently there is not a specific benchmark for Islamic banks and financial institutions. Third, the seller of a commodity may ask for a security to ensure the prompt payment, and it may be in the form of a mortgage, lien or charge, or even the sold commodity. All that is required is that the *murabaha* price be set before the security is furnished. Fourth, since the transfer of a *murabaha* would mean the transfer of money, it cannot be securitized and sold for profit in a secondary market like other conventional debt instruments.⁹³

4. Ijara

Ijara is another term of Islamic *fiqh* that means “to give something on rent,” applying either to a person, as in the case of his hired services, or assets and property, as in a lease situation. Leasing under *ijara* is similar to conventional leasing whereby the lessee pays rent to the lessor for the usufruct of an inconsumable asset. The lessor is responsible for all liabilities associated with ownership (such as property taxes), while the lessee is responsible for the liabilities associated with use (such as utility bills). The asset may be sold in a secondary market, but with it goes the rights and responsibility of ownership of the asset. Rights to the rent alone cannot be sold.⁹⁴ Finally, and most importantly, the object being leased must be owned by the lessor.⁹⁵

⁹³ Usmani, 111-147.

⁹⁴ Ibid., 157-160, 178-179.

⁹⁵ El-Gamal, “A Basic Guide to Contemporary Islamic Banking and Finance.”

5. Salam and Istisna'

Salam and *istisna'* are the two exceptions to the rules regarding the existence and possession of a commodity prior to entering a contract to sell it. In a *salam* transaction, a buyer pays an increased price at spot in return for specific goods to be delivered at a future date. The Prophet Muhammad permitted this kind of sale after he prohibited *riba* so that farmers could acquire money in advance in order to grow their crops. This line of reasoning also applied to the Arabian traders. In brief, *salam* requires that the buyer pay the full price at the time the sale is arranged, and the commodities being sold must be exactly specified in quality and quantity, with a specific date of delivery. To the consternation of modern financial institutions, payment will be in the form of commodities and not money, and the institutions cannot sell the commodities before they have taken possession. The bank can arrange for the sale of the commodities in advance through a parallel *salam*, a promise to purchase from a third party, or the commodities can be sold back to the original seller at a higher price.⁹⁶

Istisna', the second exception to the existence and possession rules, involves ordering manufactured products. Although like a *salam* where the price and specifications are fixed at the time the contract is settled, the delivery time need not be fixed and the manufacturer uses his own material. *Istisna'* can be used as a means of financing transactions like house construction with the payment made in installments, in addition to public projects like bridges or highways. The modern Buy, Operate, and Transfer (BOT) agreement is a kind of *istisna'* in which the builder accepts the right to operate the highway and collects tolls for a specified period as payment for construction.⁹⁷

⁹⁶ Usmani, 185-193.

⁹⁷ Ibid., 195-200.

6. Sukuk

Sukuk,⁹⁸ also known as “Islamic bonds,” are the *shari’a*-compliant debt instruments that represent proportional ownership in an asset or pool of assets. Until recently, issues of *sukuk* have been limited to sovereign entities, but the last few years have seen a substantial growth in the private sector. Generally, *sukuk* comprise Islamic bonds and Islamic asset securitizations. Rather than being based on the assets or cash flows from those assets, bond *sukuk* are based on the credit of the issuing entity. Securitization involves an originator transferring assets into a special purpose vehicle (SPV) which holds the asset that is being securitized. While the SPV issues the *sukuk* to investors, it also leases the asset back to the originator under an *ijara*, with the payments to the investors coming from the originators lease payments through the SPV. Payments may be predetermined or a share of the profits or losses, the majority of *sukuk* being the former. In order to be *shari’a*-compliant, *sukuk* must meet the following requirements: they are not debts of the originator; they are fractional interests in assets, usufructs, services, projects, or investment activities; they may not be issued on receivables; and the underlying business endeavor must be *shari’a* compliant.⁹⁹

Sukuk could be the foundation of the seemingly-elusive Islamic capital market, especially secondary markets, serving as a further incentive for their use in sovereign, corporate, project, or asset finance.¹⁰⁰ Global *sukuk* issuance has increased from \$20B in 2006 to a predicted \$50B in 2007, accounting for a third of bond sales in the Gulf States. In addition to Gulf holdings, *sukuk* have been used to assist Arab investors to acquire shares in such large western companies as General Electric, P&O, Sainsbury’s, Deutsche Bank, and HSBC.¹⁰¹

⁹⁸ *Sukuk* is the plural of *sakk*.

⁹⁹ Michael J. T. McMillen, “Contractual Enforceability Issues: *Sukuk* and Capital Markets Development,” *Chicago Journal of International Law* 7, 2 (Winter 2007): 427-429.

¹⁰⁰ *Ibid.*, 427.

¹⁰¹ Pamela Ann Smith, “Islamic capital markets set to soar,” *The Middle East* 382 (October 2007): 42-43.

What was originally driven by piety to be used in the construction of a utopian society has been co-opted by the very economic forces that the original pioneers berated and developed into a multi-billion dollar industry. Capitalism's law of supply and demand has brought about the growth of Islamic banking from a niche market into a global industry. Although the Islamic bank is still frequented primarily by the pious Muslim, it has evolved into something more than a tool of societal change. The next chapter will illustrate how this transformation has not been the same in all parts of the world.

III. REGIONAL DIFFERENCES IN ISLAMIC BANKING

Expanding from only one Islamic bank in 1975 to over 300 today with more than \$500 billion in assets, Islamic finance is growing an estimated 15 percent a year and is expected to continue its ascent. Growing oil wealth, a strong demand for *shari'a*-compliant financial services by large numbers of immigrant and non-immigrant Muslims, and the attractiveness of the competitive Islamic financial instruments to Muslim and non-Muslim investors are touted as being behind the sector's strong growth. The foreign and domestic Islamic debt markets have been the most rapidly growing segments of Islamic finance. For example, in Malaysia, Islamic securities accounted for total outstanding private debt and bonds at 42 percent and 25 percent, respectively. While the *sukuk* market is enjoying rapid development, holders tend to keep bonds to maturity, restricting secondary market trading. Islamic investment funds, comprising such categories as equity, real estate and property, commodity, and leasing, are in demand in the Gulf countries and Malaysia, with the preferred equity funds enjoying 25 percent growth in assets from 1997 through 2003.¹⁰²

According to Mohsin Nathani, CEO and managing director of Citi Islamic Investment Bank, Citigroup's *shari'a*-compliant wing, "GCC liquidity is fueling the growth of both Islamic and conventional finance, but Islamic finance is growing notably faster." With the saturation of local equities and real estate, GCC investors are looking for new religiously-acceptable investments, often outside of the region. Not only is GCC money expanding operations into Asia, but it is also funding Islamic banking in the West.¹⁰³ Islamic banking is not the same in all countries, however, and the difference is not just whether the country's population is primarily Muslim or Christian. The nature of the Islam practiced, the political climate, and the socio-economic conditions shape the form of Islamic banking that is prevalent in the country. Islamic banking in the Middle

¹⁰² Mohammed El Qorchi, "Islamic Finance Gears Up," *Finance and Development*, 42, no. 4 (December 2005), <http://www.imf.org/external/pubs/ft/fandd2005/12/qorchi.htm>.

¹⁰³ Clare Dunkley, "Crescent rising," *Middle East Economic Report*, 50, 43 (27 Oct – 02 Nov 2006): 4-5.

East and Asia followed parallel, yet independent, tracks of development, while its development in the West came after the industry was firmly established in these regions. Overall, the Islamic financial products produced in the Middle East and North Africa tend to represent a stricter interpretation of *shari'a*, while those produced in Asia tend to be of a more liberal bent. The West follows the basic capitalist tenet of supply meeting demand.

A. STRUCTURE OF AN ISLAMIC BANK

Depositors can make two types of deposits with Islamic banks: transaction and investment. A transaction account works like a conventional checking account where the face value of the amount is guaranteed, earns no interest, and incurs a service charge. Whereas a conventional bank will use deposit insurance as the guarantee against loss, an Islamic bank “guarantees” the value of the deposit by not using the money for any kind of risky investment. The transaction side of an Islamic institution is essentially expected to hold 100 percent reserves. The investment deposits are more important for an Islamic bank as they provide the funds for the bank’s profit and loss sharing (PLS) ventures. Unlike the secure transaction accounts, the investment accounts are shares or equity in the bank, with no fixed or promised rate of return, their value dependent upon the profitability of the bank which is based on the profitability of the bank’s joint ventures. The only guarantee an investment depositor has is the pre-arranged profit and loss ratio that is fixed for the life of the contract unless the bank and depositor mutually agree to alter the ratio. The depositors fall on the liability side of a bank’s balance sheet, while the shares of the financed joint ventures make up the assets. In theory, Islamic banks are deterred from investing in speculative ventures because the risk of loss is transferred from the entrepreneur to the lender.¹⁰⁴

As previously mentioned, the preferred methods of equity-based lending are *mudaraba* and *musharaka*. Under a *mudaraba* agreement, the bank would provide the funding and the entrepreneur the management or technical expertise. With a *musharaka*, the bank and the entrepreneurs both provide funding. The primary tool used by Islamic

¹⁰⁴ Akacem and Gilliam, 128-129.

banks, however, is the *murabaha*, a consumption loan whereby the bank buys a product for a customer and sells it to him at cost plus a mark-up in compensation for the bank's risk and time-value of money. The borrower pays back the money in installments. The *mudaraba* and *musharaka* are considered medium to long-term investments, while the *murabaha* is considered a short-term contract.

Engaging in PLS investing carries with it additional costs not normally born by a conventional institution. To begin with, the bank must do costly project appraisals since its profitability is based not merely on an entrepreneur's use of the bank's money but on the profitability of the investment. It must go beyond the conventional bank's requirement to investigate a borrower's credit and collateral, engaging in costlier underwriting. Additionally, the Islamic bank must oversee or audit projects as part of certain PLS schemes, adding costs that put Islamic banks at a disadvantage with respect to conventional banks. These added financial liabilities are what push banks to utilize the low-maintenance *murabaha* over *mudaraba* and *musharaka*.¹⁰⁵

Ironically, Islamic banks, initially lacking experience and resources, relied heavily on the conventional international banking system for its very creation. As the financial world went through significant transformations, the Islamic banks cooperated with Western banks through joint ventures, management agreements, technical cooperation, and correspondent banking in order to stay relevant and viable. This resulted in increased collaboration and synergy between the conventional and Islamic financial worlds. Moreover, the major Islamic banking groups would rather remain in the global banking system rather than try to create a global Islamic network that would compete with the global conventional banking system.¹⁰⁶

The convergence of conventional and Islamic finance can be seen in five recent trends. First, practically every conventional bank in the Islamic world offers their customers a choice between conventional or Islamic banking through Islamic subsidiaries and/or 'Islamic windows' in their conventional facilities. Second, conventional

¹⁰⁵ Akacem and Gilliam, 127, 131.

¹⁰⁶ Warde, 107-108.

institutions outside of the Islamic world, such as Merrill Lynch, HSBC, and UBS, have created Islamic subsidiaries or offer Islamic products in the hope of catering to the Islamic middle classes. Citicorp, for example, opened an Islamic subsidiary in Bahrain in 1996. Third, Islamic institutions, in an effort to attract non-Muslims, are creating products that are attractive credit-rated, medium-to-long term investment opportunities that are also *shari'a* compliant. Fourth, Islamic banks have expanded to areas outside of the Islamic world to not only service local Islamic communities but also to participate in long-term industrial and infrastructure projects in parts of the non-Muslim world. Fifth, conventional and Islamic institutions are cooperating in conducting much of the new *ijtihad* (legal reasoning) to develop new Islamic financial tools, often outside of the Islamic world. Institutions like the National Commercial Bank, the Islamic Development Bank, Wellington Management, and Goldman Sachs, in partnership with members of the DMI group, are providing financing for groups like the aforementioned Harvard Islamic Financial Information Program (now known as the Islamic Finance Project, or IFP) which seeks to collate information on the Islamic financial sector, promote research and development of new strategies and methods of Islamic finance, and increase awareness and understanding of Islamic finance in both the Western and Muslim worlds.¹⁰⁷

B. ISLAMIC BANKING IN THE MIDDLE EAST AND NORTH AFRICA

The Islam practiced in the Middle East and North Africa (MENA) tends to be of a more literal and strict variety than practiced in other parts of the world. Additionally, the role of the *ulama* and Islamists and their relationships with the governments is unique. All three elements have directly influenced the ways in which Islamic banking has been developed and conducted in the region.

1. Saudi Arabia

Saudi Arabia has experienced something of a banking anomaly in the Middle East. While the self-proclaimed Islamic country claims the *shari'a* as its constitution,

¹⁰⁷ Warde, 86-87; Harvard Law School Islamic Finance Project, "Project Overview," <http://ifptest.law.harvard.edu/ifphtml/index.php>.

until recently the majority of the banking was conventional. With the monarchy having much of its oil wealth deposited in domestic and overseas conventional bank accounts, it was hesitant to open the door to Islamic banking for fear of its populace questioning the ruling monarchy's conventional banking endeavors, undermining its Islamic legitimacy.¹⁰⁸ Although the aforementioned Ar-Rajhi Banking and Investment Company (ARABIC) began its Islamic financial operations in 1985, the National Commercial Bank (NCB), Saudi Arabia's largest commercial bank, tested the Islamic banking market in 1991 by making one of its conventional retail branches *shari'a*-compliant. Demand for Islamic banking services reached such a level that by 2004 the government and the NCB decided to make all of its 260 retail branches *shari'a*-compliant. The past decade has seen a rise in Islamic banking, from 30% of total banking at the end of 2000 to over 50% by the end of 2006. Growth in this sector in Saudi Arabia has been so much greater than in the conventional sector that the latter may eventually be abandoned.¹⁰⁹

Although Saudi Arabia once heavily regulated its banking sector and tightly controlled foreign investment, the demand for *shari'a*-compliant banking services has increased growth and expansion overseas. Not only is ARABIC opening another 160 domestic branches (it currently operates 400 and 100 branches for male and female account holders, respectively), but it is also expanding overseas to Malaysia, Pakistan, and Bangladesh. Additionally, Saudi Arabia has begun to open its borders to competition - the National Bank of Kuwait opened a Saudi branch in 2006. Although full liberalization is not planned in the near-term and the kingdom still strictly regulates foreign banking investors, the growth in Islamic banking in Saudi Arabia has made it the dominate sector in the country's banking industry.¹¹⁰

¹⁰⁸ Warde, 208.

¹⁰⁹ "Demand leads to dominance," *Financial Times*, May 23, 2007, Special Report on Islamic Finance.

¹¹⁰ Neil Ford, "Saudi Banking Goes International," *Middle East*, (March 1, 2007): 48-50.

2. Bahrain

Since the Bahrain Islamic Bank was established in 1978, Bahrain has grown to enjoy the highest concentration of offshore Islamic financial institutions. Bahrain's journey to be the Gulf's leader in offshore Islamic banking began in the 1970s when the Lebanese civil war left a regional banking vacuum.¹¹¹ The Bahrain Monetary Agency has endeavored to promote Bahrain as an international financial center since the agency's establishment in 1973, part of the country's initiative to diversify away from its dwindling oil supplies. In selling itself as a regional financial hub, Bahrain has touted its many competitive advantages, such as a skilled workforce, business-friendly environment, liberal currency exchanges, and, especially, a good regulatory system. In addition to the issuance of best practice guidelines, modeled after the United Kingdom, in 1997, all Bahraini banks must comply with the International Accounting Standards (IAS).¹¹² Bahrain is solidifying its leading role in Islamic finance by hosting multilateral regulatory institutions that endeavor to set the standards for Islamic finance: the Accounting and Auditing Organizations for Islamic Financial Institutions, the Liquidity Management Center, the Islamic International Rating Agency, and the International Islamic Financial Market.¹¹³ Currently, 50 of Bahrain's 391 licensed financial firms are Islamic, while an additional 20 conventional banks offer *shari'a*-compliant services.¹¹⁴

3. Kuwait

The Kuwait Finance House (KFH), established in 1977, is the sole Islamic Bank in Kuwait, but it has captured 15 percent of the Islamic financial market in the region, placing Kuwait among the top three countries in terms of Islamic share of commercial bank deposits. Not merely a financial endeavor, the KFH is the product of Islamists' efforts to expand their influence, representing a synergy of economic activity and Islamist

¹¹¹ Simeon Kerr, "New battleground to reassert credentials," *Financial Times*, May 23, 2007, Special Report on Islamic Finance.

¹¹² Warde, 128.

¹¹³ Kerr.

¹¹⁴ Ibid.

politics, resulting in an institutional expression of Kuwait's Islamic movement. The KFH enjoys substantial government support, originally established with a 49 percent government share in capital, the present share being nearly 60 percent. The alliance between the government, the ruling al Sabah family, and the Islamists was formed as a counter to the de-facto alliance of the pan-Arab opposition and the large Palestinian expatriate community working in Kuwait in the 1970s. With encouragement from the Egyptian Islamists, Kuwaiti Islamic entrepreneurs finally prevailed upon the Kuwaiti government to allow them to establish the interest-free financial institution in 1977.¹¹⁵

The KFH captured the market of Kuwait's conservative population and middle class by emphasizing the Islamic bank's interest-free services and criticizing the country's conventional banks for exploiting the Kuwaiti consumers of their limited income. The KFH was also able to attract a large number of its customers who were lower-income earners due to it not having minimum balance requirements. This translated into a large percentage of Kuwait's citizens banking at the KFH. Many of these lower-income Kuwaitis were the Bedouin, an oft-neglected, yet important, constituency. This penetration of the Bedouin market correlated with Islamist penetration of Kuwait's outer, more tribal districts, shifting the Islamist constituency from the urban to the tribal centers.¹¹⁶

4. Sudan

The complete Islamization of all banking in Sudan began when Jaafar al Nimeiri and his "Free Officers" seized power in 1959. Although a Nasserist in ideology, an attempted communist coup in 1971 realigned al Nimeiri's political views, transforming this initially secular leader into an Islamist. The constitution of 1973 reflected his leanings, stating that all legislation shall be based on Islamic law and custom. The Muslim Brothers became closely associated with the Sudanese government when Nimeiri signed the National Reconciliation Pact in 1978, enabling them to successfully compete

¹¹⁵ Kristin Smith, "The Kuwait Finance House and the Islamization of Public Life in Kuwait," in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 168-172.

¹¹⁶ Ibid., 173, 177.

for parliamentary seats.¹¹⁷ The national banking system, however, was conventional and disliked by many Sudanese Muslims for its interest-based operations. The Faisal Islamic Bank of Sudan (FIBS) was the first solely Islamic bank in Sudan. Established in 1978, the bank pursued an aggressive growth strategy and enjoyed an annual average growth rate of 70 percent, even as it deducted a 10 percent *zakat* from net profits for distribution to the poor. FIBS' strong growth encouraged the establishment of more Islamic banks in Sudan, though some were Islamic in name only.¹¹⁸ The proclaimed "Islamic revolution" of 8 September 1983 Islamized Sudanese society, with guidelines enacted in December requiring that the entire banking system be *shari'a*-compliant, outlawing interest. Additionally, the Zakat Tax Act of 1984 empowered the government to levy, collect, and distribute *zakat*, replacing the majority of the country's tax system. Although this legislation also created other Islamic banks, the transformation of the banking industry was inconsistent due to the haphazard nature of the Islamization process.¹¹⁹ Moreover, although courts were forbidden to enforce interest-based contracts, conventional banking continued much as before.¹²⁰

In spite of the early success of the FIBS, overall banking performance has been dismal due to such factors as the horrible performance of the Sudanese economy through the 1990s and financial abuse by members of banks' boards of directors. Although the Bank of Sudan's *Shari'a* Council has made attempts to increase bank supervision, the reforms came too late to make an appreciable difference. While Sudan's experience with Islamic finance can not be called an economic success, politically it can be considered a success in that the country's banking law is based on Islamic principles.¹²¹

¹¹⁷ Warde, 121.

¹¹⁸ Stiansen, 156-157.

¹¹⁹ Warde, 122.

¹²⁰ Stiansen, 155.

¹²¹ *Ibid.*, 164-165.

C. ISLAMIC BANKING IN ASIA

Although Islamic banking in Asia developed with the Middle East, the region's more liberal interpretation of Islam, along with the use of banking as a tool for development rather than Islamization, directly impacted its underlying philosophy and financial products.

1. Malaysia

Malaysia's Islamic financial institutions, like many in Southeast Asia, are significant for two reasons: Islamic and conventional banking systems function side-by-side, and Islam is combined with high technology and finance to achieve economic growth. Islam plays a seemingly paradoxical role in the Malaysian government in that the constitution of the secular government recognizes the primary position of Islam at the same time that it guarantees freedom of religion. While the dominant political party comprises Muslim Malays, Malaysia's Islam as practiced by its people is known for its tolerance and pragmatism, though strict traditionalists still wield influence.¹²²

Mahathir Mohammed, a physician who ascended to prime minister in 1982, engineered Malaysia's transformation from an agricultural-based economy to an Asian "tiger." His plan was to use Islam and its unique local emphasis on development, combined with such influences as nationalism, capitalism, and "Asian values," as a means by which to achieve growth, modernization, and financial innovation. In particular, he wanted to develop an Islamic financial system that would propel Kuala Lumpur into an international financial center. Often at odds with the more literal-minded *ulama* who wished to argue over details, Mahathir felt that Islam needed to be interpreted in a way to make it more relevant in the modern world.¹²³ He challenged the *ulama* to a new *ijtihad* that would adopt a more innovative approach, pushing them to create Islamic financial products that in effect mirrored the latest global financial products. Islamic

¹²² Warde, 123-124.

¹²³ James Kynge, "The very model of a modern Moslem state: The whole world will have to rethink its prejudices if Malaysia's interpretation of Islam proves successful," *Financial Times*, April 26, 1997, Special Report on Islamic Banking.

research centers and universities, such as the International Islamic University and the Malaysian Institute of Islamic Understanding, endeavored to legitimate modern finance, sending the message that industrialization and productivity were permissible under Islam.¹²⁴

The Malaysian government introduced Islamic banking as part of the New Economic Policy (NEP) strategy to assist the Muslim Malays who were bitter that their Chinese counterparts dominated the business sector and seemed to enjoy significant economic advantage.¹²⁵ Islamic banking was more than a form of patronage to mollify the Muslim Malays, however; it served as the primary means of Malaysia's development and financial modernization.¹²⁶ Although there were earlier experiments in Islamic finance in Malaysia (such as the Muslim Pilgrims Savings Corporation in 1963, evolving into the Pilgrims Management and Fund Board in 1969 - both designed to assist Muslims in performing the *hajj*), Parliament established the country's first Islamic bank by passing the Islamic Banking Act (IBA) in 1983, creating the Bank Islam Malaysia Berhad (BIMB). Controlled by the government, the requirement to adhere to Islamic principles, rules, and practices is contained in the bank's associating memorandum.¹²⁷

In addition to establishing the BIMB, the IBA provided Malaysia's central bank, Bank Negara Malaysia (BNM), with the authority to supervise and regulate Islamic banks as it does with other licensed banks. Parliament also passed the Government Investment Act of 1983 enabling the Malaysian government to issue *shari'a*-compliant Government Investment Certificates (GICs). Regarded as liquid assets, GICs provided Islamic banks a means to meet prescribed liquidity requirements and invest surplus funds. Increased governance of this nascent industry came in 1996 with an amendment to the Banking and Financial Institutions Act (BAFIA) 1989. While the original law regulated conventional

¹²⁴ Warde, 124-125.

¹²⁵ Angelo M. Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (Singapore: World Scientific Publishing Co, 2005), 155.

¹²⁶ Warde, 126.

¹²⁷ *Ibid.*, 126.

financial institutions, from banks to non-bank sources of credit and finance, the 1996 amendment allowed previously-licensed banks to conduct Islamic banking business.¹²⁸

The BIMB has been at the forefront of Islamic financial innovation - it established the Islamic insurance company Syarikat Takaful Malaysia in 1995, issued corporate *sukuk* in 1990, and created various credit and financing facilities. During this time, the government took an active role in developing Malaysia's role as a financial center, establishing the dual banking system in 1993 which permitted conventional banks to offer Islamic and conventional banking services under the same roof. Always encouraging the development of Islamic innovations that mirrored conventional products, during the 1990s the Malaysian government established a number of institutions and products with the intention of making Malaysia the leading Islamic financial center:

- a secondary market for banking products;
- an Islamic capital market in Kuala Lumpur;
- the indices and benchmarks for companies that adhere to Islamic principles; and
- *shari'a*-compliant home mortgages and credit cards.¹²⁹

With Mahathir's urging, the BNM established the National Shari'a Advisory Council (NSAC) in 1997 to avoid discord among rival Islamic schools of thought and lend legitimacy to Malaysia serving as the hub for Islamic finance.¹³⁰ The primary duties of the NSAC are to serve as the sole advisory authority to the BNM on Islamic banking operations and to evaluate new Islamic products created by Islamic banks for *shari'a* compliance. While the Malaysian government has encouraged Islamic banks to choose their own approach to interpret Islamic law in the development of financial products, unlike Islamic banking in the Middle East the NASC has endeavored to ensure overall *shari'a* compliance and standardization, benefiting Malaysia's Islamic banking sector in

¹²⁸ Venardos, 157.

¹²⁹ Warde, 126-127.

¹³⁰ Ibid., 125.

general. Also lending legitimacy to Malaysia's financial products, the Islamic Financial Services Board (IFSB) was established in Kuala Lumpur in 2002 under the sponsorship of the International Monetary Fund. The IFSB is an association of central banks, monetary authorities, and other institutions chartered with regulating the Islamic financial services industry.¹³¹

Currently, there are ten wholly Islamic banks and 13 conventional banks that offer Islamic products and services, comprising a total of 548 branches throughout the country.¹³² Along with interest-free banking, Malaysia has been operating an Islamic debt securities market since 1990, an Islamic Interbank Money Market since 1994, and an Islamic equity market since 1995.¹³³ As of May 2007, Islamic banking assets have grown to \$34B, equaling 13% of the market.¹³⁴

2. Indonesia

Despite Indonesia having the world's largest population of Muslims, Islamic banking¹³⁵ got a late start in Indonesia due to the local practice of Islam and political factors. Ever since Islam's introduction into the region, Indonesia practiced the faith in a way that differed greatly from that practiced on the Arabian Peninsula, incorporating elements of pre-Islamic Hindu-Buddhism into the local Islamic customs. This divergence in orthopraxy resulted in a more liberal interpretation of *shari'a*¹³⁶ - many secular intellectuals disagree with the prevalent belief held by Indonesian Islamic jurists that the *riba* forbidden by the *Qur'an* is the same as the modern interest charged by conventional banks. The majority of Indonesian Muslims seem to be indifferent.¹³⁷

¹³¹ Venardos, 158-159, 170.

¹³² Malaysia Industrial Development Authority, Banking and Finance, <http://www.mida.gov.my>.

¹³³ Venardos, 155.

¹³⁴ "Experience and regulation bring strength in depth," *Financial Times*, May 23, 2007.

¹³⁵ Referred to as *shari'a* banking in Indonesia.

¹³⁶ Venardos, 173-174.

¹³⁷ Mohajjad Ariff, "Islamic banking," *Asian-Pacific Economic Literature*, 2, No. 2, September 1988, <http://www.aghayan.com/islbank.htm>.

Indonesia's political secularism is reflected in the country's secular constitution which recognizes a single God, but neither Allah nor Islam is mentioned.¹³⁸ Additionally, the Indonesian government has long regarded Islamism with suspicion. After communism, President Suharto had long considered militant Islam as his next biggest threat.¹³⁹ Suharto's opposition to political Islam softened, however, with the rise of an Islamist opposition, and he began courting religious leaders and the more devout Indonesians, supporting the public's demand for a new Islamic banking system. Indonesia's first Islamic bank, Bank Muamalat Indonesia (BMI) opened in 1992 and has spearheaded the development of an Islamic financial center in Indonesia.¹⁴⁰ Islamic banking operations were laid out in the Act No. 72 of 1992 and further advanced in the Act No. 10 of 1998, including the establishment of the dual banking system.¹⁴¹ Between 1992 and 1998 there were 78 rural Islamic banks and one commercial Islamic bank in operation.¹⁴²

Bank Indonesia (BI) entered the world of Islamic banking with the passage of Act No. 23 in 1999. Like Malaysia's BNM, BI is the regulatory authority for conventional and Islamic banking in Indonesia and has taken the lead in developing the industry. Mandated by the Banking Act to establish a sound Islamic banking system, BI has established an Islamic Banking Development Committee to oversee the development of the industry and codify a more comprehensive set of Islamic banking regulations. In its "Blueprint of Islamic Banking Development in Indonesia," BI has laid out a plan that would ensure better *shari'a* compliance, improve competitiveness, and adopt international standards for Islamic banking services.¹⁴³

¹³⁸ Warde, 213.

¹³⁹ Ariff.

¹⁴⁰ Warde, 214.

¹⁴¹ Venardos, 177.

¹⁴² Bank Indonesia, "The blueprint of Islamic banking development in Indonesia," September 2002, http://www.bi.go.id/NR/rdonlyres/9170EE41-7D9A-4376-B520-A6B3A0945153/1331/syariah_bprintengl.pdf: 4.

¹⁴³ Ibid., 2.

In spite of annual growth exceeding 75%, Islamic banking constitutes less than 1% of the banking market share in Indonesia. Still in its infancy, Islamic banking in Indonesia is going to face numerous challenges as it tries to grow and compete internationally: lack of a complete regulatory and supervisory framework, limited market coverage, limited institutional expertise in Islamic banking, operational inefficiency, market domination by conventional financing, and compliance with international Islamic banking standards.¹⁴⁴ Although there are predictions that Indonesia is the “sleeping giant” that will capture 5% of the market share by 2010,¹⁴⁵ this sector in the world’s most populace Muslim nation is still in its embryonic stage of development and influence.

3. Pakistan

Pakistan’s experience with Islamic banking has been paradoxical. Pakistani Islamic economists like Mawdudi advanced the idea of Islamic finance during the 1950s, and the idea for the creation of an Islamic bank was adopted during an Islamic summit conference in Lahore. Ironically, Pakistan, also a self-described Islamic country, has not been successful in adhering to the prohibition of *riba* in its banking. Although the Pakistani constitution requires that the government operate an interest-free economy and financial system, the government has only made a half-hearted attempt to comply. Following the orders of President Mohammad Zia-ul-Haq, in 1980 the Council of Islamic Ideology (CII) created the blueprint for an interest-free economy, warning that it would not function without the restructuring of personal and state institutions along Islamic lines. Not only did this not happen, but President Zia took action countering his order by mandating a ten-year ban (1980-1990) on the Federal Shariah Court (FSC) ruling against government transactions involving interest. Additionally, the State Bank of Pakistan (SPB) permitted financial institutions to invest income from their interest-free, PLS activities in interest-bearing government securities.¹⁴⁶ Moreover, foreign currency deposits, foreign loans, and government debt still fell under the purview of conventional

¹⁴⁴ Indonesia, “The blueprint of Islamic banking development in Indonesia,” 5, 9.

¹⁴⁵ Venardos, 185.

¹⁴⁶ Mohammad Mansoor Khan and M. Ishaq Bhatti, “Why interest-free banking and finance movement failed in Pakistan,” *Humanomics*, 22, 3 (2006): 146-147.

banking. The Pakistani authorities endeavored to not disrupt the operations of the existing banking structure with the Islamic banking guidelines.¹⁴⁷

Even after the expiration of the moratorium on decisions that might prohibit interest, the government continued to make only half-hearted attempts to Islamize the banking center, primarily as a means of placating Islamist opposition.¹⁴⁸ In 1992 the FSC ruled as un-Islamic any interest paid or charged by any financial institution. The government followed in 1998 with the elimination of *riba* from the country's economy, at least in principle.¹⁴⁹ Again, however, the government had no intention of making its banking system interest-free as it relied on conventional banks for funding.¹⁵⁰

There are a number of reasons that Islamic banking in Pakistan never fulfilled the potential that many Islamic economists had hoped it would. First, the government viewed the promotion of Islamic banking as a political tool, never intending to do away with the conventional system that was a crucial source of government funding. After having undergone reforms in the early 1990s to attract foreign capital, policy makers were not about to take actions that might precipitate foreign capital flight. Deep in debt, the government would not risk not meeting its financial obligations to foreign governments and other creditors due to a loss of foreign trade, investments, and capital inflow that might accompany the abolishment of interest from the Pakistani economy.¹⁵¹

Second, the government's lack of enthusiasm for Islamizing the economy discouraged the State Bank of Pakistan (SBP), responsible for the regulation of the monetary and credit system and the de facto backroom office of the Ministry of Finance, to take the steps necessary to implement such a change. Additionally, the lack of a discount rate would deprive the SBP of the monetary tool for maintaining price stability and controlling the exchange rate.¹⁵² Third, investors and banks were hesitant to engage

¹⁴⁷ Warde, 115.

¹⁴⁸ Khan and Bhatti, 147.

¹⁴⁹ Warde, 116.

¹⁵⁰ Khan and Bhatti, 147.

¹⁵¹ Ibid., 157-158.

¹⁵² Ibid., 148-149.

in the PLS method of Islamic banking, where most of the debt instruments were simply mark-up schemes that resembled conventional finance. Depositors and bankers alike were also risk averse and more focused on the short term.¹⁵³ Bankers were reluctant to enter into PLS agreements with businesses that kept two sets of accounting books in order to avoid an excessive tax burden, and business owners tended to be private about their operations.¹⁵⁴

In spite of these past lukewarm efforts, Islamic banking is attempting to keep a toehold in Pakistan. Currently, Islamic banks' share of the market is well below three percent, but the SPB will be issuing an Islamic equivalent of treasury bills that will be an important investment opportunity for six Islamic banks that have been licensed in Pakistan. Based on the government's past disinterest in Islamic banking, with the exception of its use as a political tool, any growth in this nascent industry will be due to the interest of pious Muslims from the Middle East looking for investment opportunities. In addition to property developments in Karachi and Islamabad, the Dubai Islamic Bank is looking to establish 50 branches in Pakistan over the next three years.¹⁵⁵

D. ISLAMIC BANKING IN THE WEST

The West has been mixed in its reception of Islamic banking. While it may have not had a problem with it culturally, the regulatory regimes of some countries have been friendlier than others to Islamic banking. Fortunately western financial corporations have not been bound by these regulations when investing in the Islamic financial industry in MENA and Asia.

1. The United Kingdom

In addition to conventional Western banks opening Islamic windows in Muslim countries, these same banks have been answering the demand by Muslims in their home

¹⁵³ Warde, 116.

¹⁵⁴ Khan and Bhatti, 147.

¹⁵⁵ Farhan Bokhari, "Special Supplement: Islamic Finance - Promise in Pakistan - If Pakistan Successfully Launches an Islamic-compliant Treasury Bond, It Will Lift The Growth Potential of the Country's Embryonic Islamic Banking Sector," *The Banker*, April 1, 2007, 1.

countries. With such heavies as HSBC and Lloyds offering Islamic financial services, London has grown into the center for Islamic banking in the West, to the point of rivaling the market shares of Bahrain, Dubai, and Malaysia. The United Kingdom leads all other Islamic financial centers in the volume of commodity *murabaha*, will be the first western country to issue a *sakk*, has already established a secondary market for this instrument, and is creating Islamic hedge funds. In addition to providing a liberal banking environment, the government is changing its laws to make the regulatory environment more Islamic-banking friendly. Having lifted the double stamp duty on Islamic residential mortgages and property loans, legislation is also in the works that would give companies issuing *sukuk* the same tax relief as companies issuing conventional bonds.¹⁵⁶

The banking sector is embracing this burgeoning financial industry, with the Bank of England, the UK's central bank, issuing a directive to banks to develop *shari'a*-compliant financial products and loosening prior banking restrictions that made Islamic banking difficult.¹⁵⁷ With such changes, banks from the Middle East are beginning to use the UK as a beachhead for further expansion into the European Union. The UK's Financial Services Authority (FSA) recently granted operating licenses to the Islamic Bank of Britain (IBB), Europe's first stand-alone Islamic bank, and the European Islamic Investment Bank, both of which are backed by Islamic financial institutions in Qatar and Bahrain. Western rating agencies, such as Moody's and Standard & Poor's, are also engaged in the nascent industry, giving *shari'a*-compliant institutions and instruments standard ratings that reflect the credit risk for investors unfamiliar with Islamic finance.¹⁵⁸

¹⁵⁶ David Oakley, "Capital takes a leading role," *Financial Times*, May 23, 2007, Special Report on Islamic Finance.

¹⁵⁷ Sanjay Suri, "Religion: British try to bank the Islamic way," *Global Information Network*, July 27, 2005, <http://libproxy.nps.edu/login?url=http://proquest.umi.com.libproxy.nps.edu/pqdweb?did=873416791&sid=1&Fmt=3&clientId=11969&RQT=309&VName=PQD>.

¹⁵⁸ Dunkley, 4-5.

2. The United States

Other parts of the West, in spite of large Muslim populations, have not been as quick to embrace Islamic financial institutions. In particular, in the United States there are state and federal laws that preclude many operations typical of Islamic institutions, such as banks directly owning real estate or owning shares in a company to which they are lending money.¹⁵⁹ Additionally, the Truth in Lending Act requires that the interest rate of a financial product be disclosed, the notion of which goes against *shari'a*. While Islamic products and services are offered in the United States, there have been no strictly Islamic banks established under the existing state and federal regulations. The regulatory regimes for the states and federal government are sufficiently different that Islamic financial institutions will want to research their potential banking supervisory agencies to determine under which one they would want to operate as some more than others will be more flexible about molding a regulatory regime around unconventional banking practices. Although a financial company may conduct *shari'a*-compliant banking operations, it is not a “bank” until it meets the statutory and regulatory banking requirements. Moreover, such an institution may not legally accept deposits until it has received a charter under these requirements. An exception to the aforementioned restriction on banks owning real estate would be the savings association, which is permitted to use subsidiary servicing companies to enter into joint ventures and own property.¹⁶⁰

An additional regulatory requirement is the insurance of deposited funds by the Federal Deposit Insurance Corporation (FDIC). While transaction accounts that contain funds separate from PLS ventures can adhere to this regulatory requirement, insuring investment funds could be problematic as risk must be shared between the two parties in order to be compliant with *shari'a*. Although it would be hard for the FDIC and the relevant regulatory authority, without legislative intervention, to issue a charter to a bank that does not insure such deposits against loss, there is a possibility for compromise along

¹⁵⁹ Josh Martin, “Islamic Banking Goes Global,” *Middle East* (Jun 2005): 53.

¹⁶⁰ J. Michael Taylor, “Islamic banking - the feasibility of establishing an Islamic bank in the United States,” *American Business Law Journal*, 40, 2 (Winter 2003): 403-405, 413.

the lines as that enjoyed by the United Kingdom's IBB. The IBB satisfied both secular and religious requirements by offering to reimburse any losses incurred by an investment account, an opportunity that a devout depositor is able to decline in order to be compliant with *shari'a*. Until there is an industry-wide *shari'a* supervisory board, eagerness to make such a compromise may vary from one board to another. Additionally, regulators will be walking a fine line in keeping church separated from state when they start delving in matters that could involve religion.¹⁶¹

Islamic banking has expanded into a transnational industry, with once country-specific banks operating internationally. The success of such expansions is not solely dependent upon good business practices, however, but on customers' interpretations of Islam. The disparity in *shari'a* interpretation between the stricter Gulf and the more liberal Malaysia is the major obstacle to international standardization, according to Khalid Hamd, executive director of banking supervision at the Central Bank of Bahrain. The market will favor the GCC, however, due to its abundance of wealth, allowing *shari'a* interpretations from GCC institutions to set the international standard for structuring Islamic financial instruments. This global industry is not without its weaknesses, however, and its opportunities, as will be explored in the next chapter.

¹⁶¹ Michael Silva, "Islamic Banking Remarks," *Law and Business Review of the Americas*, 12, 2 (Spring 2006): 208-210.

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IV. LIABILITIES AND OPPORTUNITIES

While at first glance the benefits of Islamic finance might seem to bring stability and a more equitable distribution of wealth within a society, there are weaknesses in how it is currently practiced that could undermine its long-term viability. Criticisms of the system include unfulfilled expectations, structural corruptibility, insufficient regulation, and political abuse. In spite of these weaknesses, Islamic banking can play a role in moderating Islamist movements that begs exploration.

A. ENHANCED FINANCIAL STABILITY

Three areas have been identified as needing special attention for strengthening the international financial architecture that affects financial stability: enhancing transparency and accountability, strengthening domestic financial systems, and managing international financial crises. Transparency and accountability will be improved through strengthening regulations and supervision, increasing market discipline, and implement international standards. Risk management is the key to strengthening domestic financial systems and managing international financial crises. More specifically, the Working Group on International Financial Crises recommended risk-sharing schemes whereby governments of emerging markets encourage risk-sharing contracts between debtors and creditors.¹⁶² Islamic economists like Sayyid Abul-Ala Mawdudi, Muhammad Baqir as-Sadr, and Muhammad Taqi Usmani would say that such advocated profit sharing is at the heart of Islamic banking.

Islamic economists criticize conventional banking's debt financing because a seemingly unlimited deposit insurance system socializes loss and permits the privatization of gain.¹⁶³ They also extol the virtue of its profit and loss sharing financial arrangements, specifically making three claims regarding interest-free banking enhancing

¹⁶² Ahmed Mohamed Ali, "The Emerging Islamic Financial Architecture: The Way Ahead," in *Proceedings of the Fifth Harvard University Forum on Islamic Finance* (Cambridge: Center for Middle Eastern Studies, Harvard University, 2003): 149-150.

¹⁶³ Akacem and Gilliam, 124.

financial stability. First, depositors with investment accounts in an Islamic bank share in the bank's losses, encouraging the depositors to remain vigilant about the bank's endeavors. Second, the tying of debt instruments to real assets precludes the mass movements of funds that can accompany the potentially destabilizing speculation in interest-based, short-term debt typical of conventional banking. Having money assigned to specific goods and services constrains excessive credit expansion. Third, debt crises are less likely to occur in an interest-free financial system due to the total value of the debt being set when the contract is established - the total value can not increase because there is not compound interest accruing on the outstanding balance. Additionally, there is little room for fraud because there is an identified asset tied to the loan.¹⁶⁴

Islamic financiers further view their system superior to conventional venture capitalism because they do not rely merely on demonstrated credit worthiness. Proponents of Islamic banking argue that decisions regarding loans are based on overall project profitability and would not avoid a sound project simply because it would not turn a profit immediately. They view this ability to look at projects with a longer timeline as contributing to the more efficient allocation of credit.

B. CRITICISM AND CONCERNS

1. Incongruent Goals and Results

Islamic banks have fallen short of their initial socio-economic goals of distributing wealth and raising the poorer elements of Muslim society. Government support and privileges notwithstanding, Islamic banks have proven rather risk-averse, foregoing many PLS instruments in favor of more short-term financial products like *murabaha* at the expense of investments in agriculture or industry.¹⁶⁵ Islamic banks tend to go with established producers and merchants, favoring the more low-risk but lucrative trade and commodity financing to project financing, having suffered from a lack of talent capable of accurately assessing project risk. Entrepreneurs have also concealed risk from

¹⁶⁴ Ali, 150.

¹⁶⁵ Warde, 175.

the Islamic bank from which it is pursuing funds.¹⁶⁶ Additionally, the goal of eliminating interest has proven somewhat illusory, especially when involving relations with the non-Muslim world. While Pakistan, Iran, and Sudan attempted to fully-Islamicize their economies, their massive interest-bearing foreign debts prevented them from doing so.¹⁶⁷

Moreover, the many benefits associated with Islamic finance, such as it helps in redistributing wealth to the poor and its economic norms facilitate the removal of opportunism and corruption from the modern economic system, are rarely challenged or undergo the critical analysis typical of other economic programs. There are a number of reasons for this softer handling. First, the Islamic financial system is not taken seriously and is therefore not viewed as a threat to the conventional financial system. Second, an overall combined knowledge of economic theory, Islam, and the historic and contemporary Muslim world is lacking, the paucity of which precludes an evaluation of an economic program inspired and influenced by these areas. Third, the issue of cultural relativism discourages the challenge of what some would consider an “expression of authenticity” but others claim is an “invented tradition.”¹⁶⁸ Given that the rise of Islamic economics had its roots in political rather than economic grievances, there should be little surprise that Islamic finance has failed in solving the major economic problems of Muslim countries.¹⁶⁹

2. Islamic Moral Hazard

The traditional notion of moral hazard as it relates to financial regulation has been associated with policies that may encourage reckless or dishonest behavior. There can also be identified an “Islamic moral hazard” in that certain aspects of Islamic banking may be susceptible to unscrupulous conduct, specifically comprising four factors. First, the assumption of righteous behavior by employees and customers can attract more feckless characters. This was especially a problem during the infancy of Islamic banking

¹⁶⁶ Kuran, 9-13.

¹⁶⁷ Warde., 177.

¹⁶⁸ Kuran, x.

¹⁶⁹ Ibid., 64.

when many PLS schemes proved disastrous, bankers having adopted the Islamic economists' assumption that all Islamic entrepreneurs were good Muslims. Even as late as 1998, the Dubai Islamic Bank suffered scandals involving its employees and improper loan practices.¹⁷⁰ The increased scrutiny that will accompany adopting international banking regulations and Islamic banking-specific regulations should help to alleviate the consequences of such attempts at dishonesty in the future.

A second factor of Islamic moral hazard is the use of religion by Islamic institutions to avoid scrutiny or criticism. Until recently, the Islamic financial industry was believed to be above the need for regulation due to the intrinsic morality of it being *shari'a*-compliant. A third factor is the potential for ambiguity when attempting to marry economics and *shari'a*. In contrast to the secular system, the economic and religious logic incorporated in Islam's legal system encourages patience and even loan forgiveness to delinquent borrowers. Late fees or penalties are often unenforceable, with collecting on bad loans made even more difficult in many Muslim countries by multi-layered legal systems. The fourth factor, also tied to inadequate regulation, involves the relationship between banks and depositors. Although investment account holders are not promised a fixed rate of return they expect a competitive one. Banks are compelled to accommodate this expectation out of a fear of losing business, doing so by changing the profit distribution ratios in favor of investment account holders over shareholders. Egypt's International Islamic Bank for Investment and Development faced such a quandary in the late 1980s, and not only distributed all profits to investment account holders, but went so far as to make distributions in excess of its net profits. Without strict regulatory controls, such activities could continue.¹⁷¹

3. Arbitrage and Innovation

An inherent weakness of Islamic finance's over-emphasis on premodern contract forms is its potential exploitation by rent-seeking legal arbitrageurs, resulting in a kind of *shari'a* arbitrage. *Shari'a* arbitrage would be a regulatory arbitrage whereby a financial

¹⁷⁰ Warde, 154-155.

¹⁷¹ Ibid., 156-158.

product available in one market would be restructured under what is perceived as Islamic law in order to make it available in another.¹⁷² This adherence to premodern contract forms results in efficiency losses which are justified as a necessary expense of the Islamization process. Moreover, the emphasis on contract mechanics and certification of *shari'a* compliance by *shari'a* supervisory boards is at the expense of efficiency and fair pricing. As long as Islamic finance continues to focus on form over substance, such inefficiencies could eventually undermine the growth of this nascent industry that was initiated, though not necessarily sustained, by piety.¹⁷³

Constructing an Islamic financial product begins with a conventional product for which there is no Islamic alternative. Bankers, *ulama*, and lawyers work together to reengineer the conventional product to make it *shari'a*-compliant, endeavoring to make it compatible with legal and regulatory systems by making it “as similar as possible to the conventional product with which regulators are familiar.”¹⁷⁴ There is a deliberate discussion involving the tradeoff between efficiency and perceived Islamic credibility, specifically as it pertains to the use of premodern contract labels. In fact, an important step in the execution of this *shari'a* arbitrage is choosing the appropriate Arabic name for the new product, preferably one widely used in classical Islamic jurisprudence, in order to lend legitimacy to the new product. In deviating from the original conventional product, a special purpose vehicle, usually associated with a *sakk*, or other “superfluous financial transactions,” may be required in order to sufficiently change the new product from its origin and make it sufficiently Islamic. Such activity increases transaction costs and reduces efficiency. The kind of Islam practiced in the target market, Sudan versus Malaysia, for example, will determine the degree of tradeoff between credibility and efficiency and how the Islamic product will be structured. In spite of all of these efforts to Islamize the new product, rates of return are often tied to the conventional LIBOR.¹⁷⁵

¹⁷² El-Gamal, *Islamic Finance: Law Economics and Practice*, xi, 194.

¹⁷³ Ibid., xii -1.

¹⁷⁴ Ibid., 13.

¹⁷⁵ Ibid., 13-21.

Islamic finance is rarely completely unattached to conventional finance and the degrees of separation that are used to separate the Muslim customers from interest-bearing products resembles the layering techniques of money launderers and criminal financiers. Additionally, offshore financial centers are also used to minimize the incorporation costs of SPVs and tax burdens. The lack of a unified regulatory framework for Islamic finance, coupled with the lack of sophistication of regulatory and law enforcement in many of the countries in which Islamic finance is centered as compared to its western counterparts, leaves it more susceptible to abuse by criminal elements. In particular, there is a lack of transparency associated with the degrees of separation often utilized in Islamic banking. While Islamic bankers may have no interest in participating in any illicit activity regarding criminal or terrorist financing, the criminal financiers have experience in the techniques that are similar to the mechanics of *shari'a* arbitrage that may allow them to exploit the insufficiently-regulated industry.¹⁷⁶

4. Operating in a Conventional International System

The first 25 years of Islamic banking (1975-2000) was plagued by excess liquidity with no means to easily move funds between banks, a convenience enjoyed by the conventional banking industry through such instruments as treasury bills (T-bills), other tradable securities, and overnight inter-bank loans and transfers. The Bahrain Monetary Agency created the first Islamic T-bill in 2000, a non-tradable *sukuk al salam*, and in the following year introduced the first tradable Islamic debt security based on a bundle of *shari'a*-compliant leases, a *sukuk al ijara*. In 2002, Malaysia created an internationally-tradable *sakk* that was rated by Standard & Poor's and Moody's and complied with U.S. regulations pertaining to conventional global bonds. In the following years, Islamic bonds were issued by the Islamic Development Bank, Qatar, Kuwait, Dubai, and the German state of Saxony-Anhalt, culminating in the creation of the Dow Jones Citigroup Sukuk Index on April 2, 2006. Unfortunately, efficiency is sacrificed as SPVs are used in the

¹⁷⁶ El-Gamal, *Islamic Finance: Law Economics and Practice*, 23-24, 177.

formation of the complex financial package that creates contracts which on the surface are *shari'a* board certified, but in reality is merely a complex iteration of a conventional bond issue.¹⁷⁷

Although Islamic banks are enjoying the fruits of their burgeoning industry, they may feel more of a squeeze by their conventional competitors in the coming years. Whereas strictly Islamic banks were the vanguard of producing *shari'a*-compliant products, conventional banks are beginning to produce new products at a faster rate. Conventional institutions enjoy the advantage of their strategic decision-making process, being able to engage in a process of experimentation while their Islamic counterparts must receive clearance from a *shari'a* board before they can introduce new products and services.¹⁷⁸ While nearly all of the 300 Islamic banks operating in 75 countries are associated with or consult *shari'a* advisory boards, there are no international standards for *shari'a* compliance. The lack of consensus creates a wide disparity between what is considered a sufficiently Islamic financial instrument across countries and regions based on the traditions of Islam practiced in those areas.¹⁷⁹

5. Regulations and Organizations

Existing banking regulation was constructed for conventional finance in industrialized countries. Since Islamic banking is often conducted in emerging markets, usually lacking a sufficient regulatory framework and suffering from structural problems, it has found fitting into existing regulatory frameworks rather difficult. However, a number of factors are encouraging Islamic banking to fall under the international regulatory framework: the spread of liberal ideology, or the “Washington Consensus,” which advocates free and open markets and fiscal discipline; the expanded role of emerging markets in the global economy and the concomitant penetration of international financial institutions in these markets; and such financial turmoil as banking and currency

¹⁷⁷ Clement Henry, “Islamic finance: from medieval to contemporary globalization” (paper delivered to the Conference on Globalization, State Capacity, and Muslim Movements, March 16-19, in Washington, DC).

¹⁷⁸ Warde, 152-154.

¹⁷⁹ Henry, “Islamic finance: from medieval to contemporary globalization.”

crises. The increased exposure of banks and investment funds in emerging markets has precipitated an expectation that all countries will adopt norms such as the “Core Principles for Effective Banking Supervision” issued in 1997 by the Basel Committee.¹⁸⁰

The central bank governors of the G10 countries and Switzerland and Luxembourg created the Basel Committee on Banking and Supervision in December 1974 in response to the failures of Franklin National Bank in New York and Bankhaus Herstatt in West Germany. The Basel Committee has produced a number of regulatory documents since its creation that have increased cooperation among bank supervisors and established international standards. The Basel Accord of 12 July 1988 produced joint regulations affecting a minimum capital-to-assets ratio and capital classification, each subject to different rules. The committee has also addressed risk-minimization strategies, and in 1992 established the following four principles for cross-border banking supervision:

1. all international banks should be supervised by a home country that is capable of performing cross-border supervision;
2. the creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority;
3. home country authorities should possess the right to gather information from their cross-border banking establishments; and
4. if the host country determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.¹⁸¹

As a result of increased international banking crises, the G7 petitioned the Basel Committee for more detailed guidelines, specifically looking for more cooperation, transparency, and risk containment among banks and supervisors. In response to this entreaty, the committee issued, in close cooperation with 15 emerging market countries, the 25 Core Principles in 1997. It contained the following items:

¹⁸⁰ Warde, 180-181.

¹⁸¹ Ibid., 186-191.

- all banks must have comprehensive risk management systems as well as management information systems that enable management to identify concentrations within their portfolio;
- supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers;
- supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements; and
- regulators must be able to supervise the banking group on a worldwide consolidated basis.¹⁸²

Adopting the 25 Core Principles has proved somewhat problematic for the developing world in general and the Islamic world in particular. Although the Basel Committee initially considered having two sets of regulations, one for developed countries and one for emerging countries, the committee decided to adopt a single regulation for all. Although Malaysia and Indonesia were nominally involved with the construction of the new regulatory framework, most Islamic countries have had difficulty implementing the regulations due to institutional, cultural, political, and religious obstacles. In addition to Islamic banking supervisors feeling that they are sufficiently different from conventional banking to not be governed by the same standards, compliance is nearly impossible from the standpoint of ownership and control, specifically with respect to the requirement of home country regulation. Transnational groups like Prince Mohammad al-Faisal As-Saud’s Dar al-Maal al-Islami (DMI) or the Dallah al Baraka group own or control the majority of Islamic banks. The Saudi prince headquartered his operations in the Bahamas, runs his network out of banks out of Geneva, and extends his operations in all parts of the Islamic world except Saudi Arabia.¹⁸³

Internal risk management can be problematic to Islamic bankers. *Shari’a* boards tend not to address this religiously-delicate matter, especially as it relates to risk-reducing

¹⁸² Warde, 191-192.

¹⁸³ Ibid., 194.

financial instruments or deposit insurance. As a result, Islamic banks are unable to meet regulators' requirements for risk-management strategies. Regulations like the U.S. Truth-in-Lending Act, which requires banks report an "annual percentage rate" in its disclosure statements, are also problematic due to the widely-held belief among *ulama* that the *Qur'an* forbids interest. There is also a cultural barrier to such laws pertaining to disclosure due to the tendency to not discuss financial matters openly in many Muslim societies. This penchant for privacy can extend to locales where "fronts" that might conceal bank ownership are not assumed to be of nefarious intent.¹⁸⁴

Ahmed Mohamed Ali argues that Islamic banking is effective in combating terrorist financing due to its overall regulatory environment being more stringent than the recommendations of the Financial Action Task Force on Money Laundering (FATF), especially with the self-regulation of complying with *shari'a*. He further contends that the industry is inherently stable due to it being entirely asset-backed.¹⁸⁵ In spite of Ali's assertion that the Islamic banking system is sufficiently regulated, according to a McKinsey consultant there will be only national strongholds and no international Islamic banking markets until all banks abide by overarching standards.¹⁸⁶ Additionally, the risks associated with Islamic banking are sufficiently similar to conventional banking as to warrant a similar regulatory framework.¹⁸⁷ Toward this effort, a number of institutions have been established to regulate and bring the infrastructure of the Islamic financial industry closer to the conventional financial industry. These include, but are not limited to, the following:

- Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
- Islamic Financial Services Board (IFSB)
- International Islamic Rating Agency (IIRA)

¹⁸⁴ Warde, 195.

¹⁸⁵ Ali, 147.

¹⁸⁶ Roula Khalaf, "Experts see need for a common approach," *Financial Times*, May 23, 2007, Special Report on Islamic Finance.

¹⁸⁷ Dahlia El-Hawary, Wafik Grais, and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated," World Bank Policy Research Working Paper 3227, March 2004, [http://wbIn0018.worldbank.org/html/FinancialSectorWeb.nsf/\(attachmentweb\)/3227/\\$FILE/3227.pdf](http://wbIn0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/3227/$FILE/3227.pdf).

- International Islamic Financial Market (IIFM)
- Liquidity Management Center (LMC)
- General Council for Islamic Banks and Financial Institutions (GCIBFI)

The AAOIFI, which introduced its first regulations in 1993, works on two levels. First, its accounting board regulates the placement of transactions on financial statements and issues professional certifications for the Islamic banking industry. Second, it has a *shari'a* board comprising 17 religious scholars whose role is to unify the findings issued by the *shari'a* boards of individual institutions. The AAOIFI board determines the *shari'a* compliance of new products, and the members implement the rulings in their banks.¹⁸⁸ Although the board has issued a number of accounting standards since its inception, they tend to be only adaptations of the International Accounting Standards pertaining to disclosure.¹⁸⁹ Additionally, the AAOIFI is only a source of credibility, having no powers of enforcement. Only eight countries consider the AAOIFI standards as mandatory, though many other institutions use them, and Malaysia has its own regulatory agency, the IFSB, which was established under the guidance of the International Monetary Fund (IMF).¹⁹⁰ The IMF took steps in 2002 to standardize the industry by sponsoring the IFSB, which serves as the general secretary of the AAOIFI.¹⁹¹

The IIRA, which began operation in July, 2005, uses the AAOIFI accounting standards as the basis by which it examines an institution's *shari'a* compliance. Not intending to compete with other regulatory agencies, it focuses on the likelihood of default by examining fiduciary risk. Such a risk assessment endeavors to instill confidence and acceptability of new products in the Islamic financial industry. The IIFM was established in 2001 to tackle the issue of liquidity management in the Islamic financial services industry. The lack of an interbank Islamic money market requires Islamic banks to maintain a greater degree of liquidity than conventional banks, affecting

¹⁸⁸ El-Hawary et al.

¹⁸⁹ James Drummond, "Association sets new standards: REGULATION, *Financial Times*, October 26, 2000, survey section on Islamic banking.

¹⁹⁰ Khalaf.

¹⁹¹ Henry, "Islamic finance: from medieval to contemporary globalization."

competitiveness. To counter this weakness the LMC was established under the IIFM to give Islamic banks an option for short-term liquidity instruments. It operates by securitizing tangible long-term assets, issuing *sukuk* against these assets in order to be *shari'a* compliant. The LMC established a consortium of liquidity providers to create a secondary market for its products. Additionally, it utilizes an SPV to bridge the asset-rich conventional institutions with the Islamic banks, not only securitizing the assets, but also ensuring their *shari'a* compliance. The GCIBFI is focused on advancing the nascent Islamic banking industry, addressing misconceptions and other challenges through developing strategic alliances and partnerships. Finally, the *shari'a* supervisory boards of individual Islamic financial institutions ensure *shari'a* compliance to sustain depositor confidence, a necessary ingredient for financial stability. The AAOIFI is working to standardize the basic rules that would govern these boards.¹⁹²

The Islamic financial architecture will only be effective if these institutions consolidate their operations in order to provide an overarching regulatory framework for the entire Islamic financial services industry. If such a consolidation were combined with international standards of best practices a financial system could be established that is more efficient, stable, and equitable.¹⁹³

C. ISLAMIC BANKING AND ISLAMISM

As discussed in the chapter on the evolution of Islamic banking, an alliance developed between the *ulama* and the wealthy Islamic bankers that brought life to many sidelined *shari'a* scholars and encouraged many Muslims to use Islamic banks. In addition to being a marketing win for the Islamic bankers for whom the *ulama* are essentially working, the *ulama* that have hired on with Islamic banks are reaping societal and financial benefits, enjoying greater respectability and income that far exceeds their compensation as religious scholars.¹⁹⁴ Such is the demand for these *shari'a* experts that the lack of qualified experts to sit on *shari'a* boards is slowing growth of Islamic

¹⁹² Ali, 151-153.

¹⁹³ Ibid., 153-155.

¹⁹⁴ Kahf, 17, 26.

financial products.¹⁹⁵ However, the change in lifestyle that the increased wealth has allowed these fortunate members of the *ulama* to enjoy has drawn criticism from those not recruited, accusing the more fortunate scholars as being tools of the bankers and making liberal interpretations of *shari'a* to fit financial needs. Ironically, most Islamist activists now tend to ally themselves with these critical, non-aligned *ulama*. In line with financiers trying to avoid politics, the bankers have had to walk a fine line when choosing Islamic scholars, not wanting to alienate potential customers by picking ones that are government-sponsored, at the same time not wanting to choose overly-Islamist *ulama* that might cause conflict with an unpredictable authoritarian government.¹⁹⁶

Even though Islamic banking has endeavored to avoid extremists on both sides, its alliance with the *ulama* has legitimized parts of the Islamic movement in many Muslim countries, especially when Islamic banks use “moderate” Islamists. Such relationships have actually provided a kind of political space for the moderate Islamist movement, giving these moderate Islamists a peaceful haven, such as the cases in Egypt and Jordan, improving their relations with their governments. Many of these Islamists have abandoned Sayyid Qutb’s all or nothing mantra and embraced a more gradual approach to Islamizing the society. Governments approved of the absorption of these “reconciliatory reformists” by Islamic banks under the rubric of an allied *ulama*, creating a new power center that comprises a segment of the *ulama*, Islamic financiers, moderate Islamists, and professionals and bureaucrats that make up part of the secularist intelligentsia. This alliance has produced two significant socio-political achievements: a partial implementation of *shari'a* and the gradual moderation of the main Islamist movements.

The authoritarian states of the Middle East and North Africa (MENA) tend to be more open economically than politically. Consequently, Islamic financiers have greater access to the government and business elites than other Islamists, enjoying a greater degree of autonomy than political parties. While states may permit Islamic banking as a means of improving legitimacy with its Muslim constituency, the bridging capability of

¹⁹⁵ Hugh Tomlinson, “Lending credibility,” *Middle East Economic Digest*, February 16-22, 2007, 4.

¹⁹⁶ Kahf, 27-28.

Islamic financiers between the state and businesses could help precipitate social and economic change in these illiberal countries. Islamic bankers tend to promote a more “politically neutral form of Islamism” that has a greater chance of being tolerated than the more militant forms associated with the Islamist movement.¹⁹⁷ In spite of these possibilities, the Islamic banking experience has been different for all countries, especially in the Gulf. While seen as a force of moderation, it has been used as a tool for advancing Islamism, though a socially-focused, non-violent form. The popularity of Islamic banking with the general Muslim populace may find the *shari’a*-compliant business practices more attractive than the interest-driven conventional banking.¹⁹⁸

Islamic banks can foster the spread of Islamism by providing job opportunities to religious youths whose education and cultural background might have limited their opportunities in the corporate world and funneling a portion of their profits into religious education, publishing, and networking.¹⁹⁹ More than mere profit-seekers, some Islamic bankers may see themselves as “agents of social renewal,” cleansing the economy, if not the entire social system, from secular influences. Viewing *riba* as the source of such evils as injustice, corruption, inequality, poverty, and discontent in capitalist and socialist economies, by offering an Islamic alternative these Islamic bankers feel that they are fomenting a fairer and more egalitarian society.²⁰⁰ Such is the case of Islamic banking in Kuwait.

1. Kuwait Finance House

The early Islamic financiers in the Gulf were often members of the Muslim Brotherhood who sought to expand their influence through bank ownership, linking Islam with global capitalism. The Kuwait Finance House (KFH) is an example of such efforts. Established in 1977, the KFH has grown to be the second largest bank in Kuwait, trailing

¹⁹⁷ Clement M. Henry, “Islamic Financial Movements: Midwives of Political Change in the Middle East?” (paper prepared for the 2001 Annual Meetings of the American Political Science Association, San Francisco, California, August 30 to September 2, 2001).

¹⁹⁸ Ibid.

¹⁹⁹ Kuran, 6.

²⁰⁰ Ibid., 57.

only the National Bank of Kuwait, whose influence extends into real estate and leads consumer lending. As mentioned in the preceding chapter, the KFH has come to symbolize the Islamic movement in Kuwait, capitalizing on its links among businesses, government, and charities to protect and further Islamist interests at the same time that its Islamist ties protect and expand the bank. The KFH has enjoyed this success through considerable government support, “a concrete expression of the de facto alliance between the ruling family and the Islamic movement,” brought about as a counter to the Arab nationalist movement.²⁰¹

The KFH’s influence extends beyond the economic, however, promoting an Islamic social agenda and overall Islamic lifestyle - Islamic tenets in the workplace and gender segregation in society, for example. Additionally, KFH has become a center for Islamic charities to deposit their funds, going so far as to advertise its services for such purposes and making donations to numerous charities. The KFH has been the object of added scrutiny due to the suspicious political leanings of some of these charities and the lack of oversight by Kuwait’s Central Bank over the KFH. In spite of a law passed in April 2003 that was to limit KFH’s activities and bring it under the auspices of the Central Bank, the KFH is still free to invest in commercial activities up to a Central Bank-designated ceiling, and the exact nature of the regulation was left undefined. Overall, the KFH’s methods of inclusion of Kuwait’s Bedouin and middle class in the country’s economic activities has brought about an Islamization of public life that will in turn secure the demand for Islamic financial services.²⁰²

Islamic finance garners support to the broader Islamist agenda in a two-pronged approach. The philosophical argument for Islamic economics only persuades, while a successful Islamic bank persuades and builds political pressure, not only demonstrating Islam’s contribution to economic justice and efficiency, but also boosting the perception

²⁰¹ Kristin Smith, 168-172.

²⁰² Ibid., 179-186.

of Islamism's power. The result is a compounded pressure to support Islamism, altering public opinion to the point that opponents practice a form of self-censorship, ultimately weakening the anti-Islamist resistance.²⁰³

On the other hand, Islamic finance has moderating effects, the majority of its practitioners being thought of as "Muslim reformists," similar to the Islamists in their aspiration to increase the role of Islam in daily life, but lacking in their commitment to political mobilization. Bankers, as a rule, attempt to avoid, or at least give the appearance of avoiding, political engagement or activity. Moreover, most would favor the neoliberal economic reform of the Washington Consensus as Islamic financial instruments require the financial transparency and accountability that are the goals of structural adjustment programs. The current investing climate of the developing countries that practice Islamic finance is not ideal, especially for equity financing which accounts for only five percent of the current assets of Islamic banks.²⁰⁴ Islamic financing in Jordan exemplifies the way Islamic banks often must balance competing interests.

2. Jordan Islamic Bank

The Muslim Brotherhood (MB) gained significant influence in Jordan in 1970 when it supported the monarchy's expulsion of the Palestine Liberation Organization. Earning a semi-official status, the group created many new charitable and social organizations in Jordan and began discussing the feasibility of establishing Islamic banks. Sami Harmoud, a Jordanian economist with nearly 20 years experience at the Jordanian National Bank, was convinced of the merits of an interest-free financial system and began working toward establishing an Islamic bank in the 1970s. He established a Preparatory Committee for the Jordan Islamic Bank (JIB), choosing *ulama* that would be acceptable to the monarchy and the general masses, ultimately obtaining a license to begin operations in March of 1979. Although Harmoud avoided *shari'a* scholars that

²⁰³ Kuran, 62-64.

²⁰⁴ Henry, "Islamic finance: from medieval to contemporary globalization."

might be too closely linked to Islamist groups, the MB played important political and financial roles, including a secondary role in the bank's leadership and decision-making.²⁰⁵

The MB never adopted the JIB as an institution of their movement, i.e. using it as a means to advance its Islamist agenda, and has had less influence over its operation in the following years. The MB was also uninvolved in the establishment of the Arab Islamic Bank (AIB) in Jordan. Although the Islamists have touted the success of these banks as evidence that Islam is relevant for inclusion in all aspects of modern life, they feel that the banks could do more in fulfilling basic social needs and that it uses interest in its operations under an Islamic veneer. The view of the JIB by the non-Islamists has also tarnished during the mid-1990s, the assumption being that the JIB is an institution of the MB. Accordingly, the JIB has walked a fine line, trying to stay close enough to Islamist elements to not lost its Islamic credentials, but not so close as to attract government scrutiny. In supporting this course of action, the monarchy is missing an opportunity to moderate the more vocal elements of the Islamist movement by giving it a chance to frame the legal and regulatory environment that binds Islamic banks and precludes their involvement in state business. An alliance between the Islamic financiers and Islamist activists would accompany a more politically liberal environment, incentivize the latter to reduce their demands on the state, and foster a forum of cooperation and coexistence. Such a partnership could foster a process of moderation that fosters the development of civil-society institutions that could lead to a peaceful democratization of Jordan.²⁰⁶

While its apparent from the previous discussion that Islamic banking has its weaknesses, these are primarily economic in nature and do not pose a security threat. However, Islamists are involved in the industry, and though they seem focused primarily on local change, their published ideology tends to be anti-western. If Islamists with a more extremist views were to come to power, their belief in the immorality of man's involvement in governance could undermine democracy. The Muslim Brotherhood has

²⁰⁵ Malley, 191-196.

²⁰⁶ Ibid., 196-199, 207-212.

embraced Islamic banking as a part of their overall scheme of Islamizing society; fortunately their motives seem to be more socially focused, at least for now. The wahabism that is being exported is a bit more extreme.

V. CONCLUSION

In spite of the cases of certain Islamic banks being involved in some way in financing terrorist activity, there is little proof that the Islamic banking industry is connected to terrorism any more than are conventional banks. Furthermore, the recent surge in the Islamic financial sector is due to the growth in petroleum-related wealth, a Muslim piety, and portfolio diversification. Islamist groups, particularly the Muslim Brotherhood, have played an active role in the spread of Islamic banking, but the industry seems to be moderating many would-be extremists and increasing the financial opportunities for much of Islamic society. This does not mean, however, that there are not aspects of the industry that should be monitored. Like conventional banks, Islamic banks must be wary of and report transactions that seem out of the ordinary or are for nefarious intent.

The authoritarian states of the Middle East and North Africa tend to be more open economically than politically. Consequently, Islamic financiers have greater access to the government and business elites than other Islamists, enjoying a greater degree of autonomy than political parties. While states may permit Islamic banking as a means of improving legitimacy with its Muslim constituency, the bridging capability of Islamic financiers between the state and businesses could help precipitate social and economic change in these illiberal countries. Islamic bankers tend to promote a more “politically neutral form of Islamism” that has a greater chance of being tolerated than the more militant forms associated with the Islamist movement.²⁰⁷ The Islamic banking experience has been different for all countries, especially in the Persian Gulf. While seen as a force of moderation, it has been used as a tool for advancing Islamism, though a socially-focused, non-violent form. The popularity of Islamic banking with the general Muslim populace is due to *shari’a*-compliant business practices being more attractive than interest-driven conventional banking.²⁰⁸

²⁰⁷ Henry, “Islamic Financial Movements: Midwives of Political Change in the Middle East?”.

²⁰⁸ Ibid.

Contrary to the idea of Islamic banking's nefarious connections, Malaysia has used this new financial sector as a means of providing jobs to many of its Islamists who were graduates in religious studies, turning them "away from the path of revolution."²⁰⁹ This was also the case in many parts of the Middle East. Although groups like the Muslim Brotherhood used Islamic banks as a tool for advancing their Islamic agenda, there is little evidence to connect the more socially-concerned agendas or the actual deposited funds with terrorism. Additionally, the more salutary effects of giving the potentially-radicalized Islamists financial opportunities and involving the traditionally disenfranchised members of society in the modern financial system more than outweigh the anecdotal suspected involvement of Islamic banks in financing terrorism. This being said, one must be aware that the forces of capitalism seem to be tempering an Islamist ideology that tends to be anti-western.

A synergy that has developed between the rising Islamic capitalists in the Muslim world and the *ulama* could grow into one that is capable of persuading Muslims to turn their backs on the extremist theories of *jihad*. While not "transforming the spirit of puritan Islam," Islamic banking is providing a pious alternative to devout Muslims "who may prefer to forsake politics for business." One could argue that Islamic banking is a means of enfranchisement for the previously disenfranchised Muslim who may have been attracted to a more radical form of Islamism as an outlet for his economic, if not political, grievances. Islamic financiers may be taking the first step toward building the civil societies necessary for building democratic institutions in authoritarian states.²¹⁰

The United States should abandon its unfounded fears of Islamic banking and its supposed ties to terrorism and do all that it can to bring this nascent financial industry into the international system. As a means of leverage, it could alter its laws to make Islamic banking possible in the United States in return for greater scrutiny of operations abroad. The *zakat* collection must be more closely monitored to ensure that the collected funds are flowing to legitimate charities that do not support terrorism. Additionally, although *hawala* is not inherent to Islamic banking, most of its operations take place in

²⁰⁹ Kepel, 94.

²¹⁰ Henry, "Islamic Financial Movements: Midwives of Political Change in the Middle East?"

Islamic countries. Islamic banks could assist in curbing this system by offering low-cost wire transfers that are competitive with *hawala*. With Islamic finance being relatively new to the world of modern finance, there are many areas that could be leveraged to the benefit of the United States and Islamic banks, advancing into developing regions free of an Islamist agenda.

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